# Richard Boyns

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European Banking Authority

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Dear Sirs

**Consultation paper on prudent valuation**

HSBC welcomes the opportunity to respond to the EBA’s Consultation Paper (‘CP’) on Prudent Valuation.

HSBC is one of the world’s largest banking and financial services organisations with assets of USD2,645 billion at 30 June 2013. Headquartered in London, HSBC serves customers worldwide from around 6,600 offices in 80 countries and territories in six geographical regions: Europe, Hong Kong, Rest of Asia-Pacific, Middle East and North Africa, North America and Latin America.

HSBC recognizes that the CP presents some significant improvements compared to the previous DP and has factored in certain suggestions from the industry. Notably, we welcome the revised confidence level of 90%, which we believe to be more appropriate when assessing uncertainty. We also appreciate the introduction of a simple and realistic diversification factor of 50% applicable to market price uncertainty and close out AVAs.

HSBC is nevertheless of the view that the text could benefit from some further clarification and simplification.

Specifically, HSBC recommends;

1. A risk-based approach should be permitted for non-derivatives when estimating market price uncertainty, consistent with the principle espoused in Article 8 that AVAs should only apply to residual portfolio valuation exposures and recognising that derivatives and non-derivatives may be risk-managed together.
2. A consistent diversification treatment should be applied to AVAs when estimating diversification benefit. In particular we believe that the principles that underlie the diversification benefit between market price uncertainty and close out AVAs also apply to model risk and concentration AVAs, and consequently an extension of the 50% diversification benefit to these AVAs is appropriate.
3. The methodology for netting risk prescribed in Article 8 and 9 should be revised in consultation with the industry. We are concerned that in practice the methodology may require excessively high correlations between risk buckets in order to achieve an offset and be difficult to apply to less liquid data. In addition, the relationship between risk bucketing and risk management practice may be lost, and superior methodologies may exist. In general HSBC advocates expert based judgement with robust and auditable documentation over formulaic approaches.
4. Prudent valuation should focus on risk factors that directly and unambiguously drive fair value. Operational risk should be capitalised within the operational risk charge, not within prudent value.
5. Offsets should be allowed against other Pillar 1 charges where application of AVAs would result in a position being more than fully capitalised. Prudent valuation should also be tax adjusted, reflecting that if the prudent value were to be realised into p&l, the actual impact on capital would be post tax.
6. The proposed back-testing procedures should be removed in favour of portfolio benchmarking exercises, as they are unnecessary for liquid positions, and likely to be ineffective for illiquid positions.

We would be pleased to discuss our comments further if this would be helpful to you and your colleagues.

Yours sincerely,

Richard Boyns

**APPENDIX: RESPONSES TO SPECIFIC QUESTIONS**

**Q1. Do you agree with the minimum list of alternative methods and sources of information defined above for expert based approaches? If not, what others could be included, or which points from the current list should be removed? State your reasons.**

We agree that the alternative methods and sources of information proposed by the CP should be given consideration and may be a sensible source of information to assess uncertainty, depending on markets and products. However, we do not support a systematic and simultaneous use of all the data listed here but rather advocate a more selective approach based on the relative relevance of these sources.

**Q2. Do you agree with the introduction of a threshold below which a simplified approach can be applied to calculate AVAs? If so, do you agree that the threshold should be defined as above? State your reasons.**

We intend to apply the core approach to all HSBC entities and do not opine on the proposed threshold.

**Q3. Do you believe there are any practical issues with a parent institution being required to apply the ‘core approach’ to all fair value positions whilst a subsidiary is allowed to apply the simplified approach? State your reasons.**

We do not intend to use the simplified approach and do not see any benefit from performing multiple computations.

**Q4. Do you agree with the proposed simplified approach? Do you think the risk sensitiveness of the approach is appropriate? Are there alternative approaches that you believe would be more appropriate? State your reasons.**

As a matter of principle, we wish to express our strong reservations with respect to the concept of unrealised gains since inception:

1. Unrealised gains are not related to valuation uncertainty;
2. Unrealised gains do not differentiate between liquid and illiquid exposures;
3. Unrealised gains depend on firm-specific matching rules between buy and sell (fifo, lifo, average cost);
4. Unrealised gains as an uncertainty measure may be counter intuitive: for example, the unrealized profits of a short volatility exposure would increase as markets calm and transparency increases;
5. The proposed treatment is asymmetric and would ignore exposures with unrealised losses;
6. Unrealised gains may be subject to manipulation through sell and buy back;
7. Unrealised gains are not a recognised concept within current fair value accounting rules, and consequently definitional issues arise and current systems architecture may not capture the information.

We would advocate the use of a set of appropriate percentages applicable to balance sheet figures and that differentiate between liquidity classes. Such % should be commensurate with or calibrated to results observed where the core approach is used.

**Q5. Could a differentiated treatment for some asset/liability classes be considered, for example with regard to their liquidity? Please state the pros and cons of such a differentiation. How would you define the degree of liquidity of an asset/liability class (e.g. fair value hierarchy, eligibility for the LCR, other)?**

We urge regulators not to introduce multiple and diverging classifications that would aim at capturing similar objectives as accounting standards but would eventually inflate the number of processes, reporting, documentation and burdensome reconciliations.

We therefore support the use of a liquidity hierarchy that would not be fundamentally dissimilar from the current accounting definition. Such an approach could be combined with the vanilla/exotic taxonomy that the CP has proposed and further enriched if it is deemed necessary.

Separately, we recognize that liquidity ratio classification may provide supplemental information but note that scope would be limited to cash products.

**Q6. Do you agree with the approach defined above to calculate an AVA where the approaches in Article 8 and 9 are not possible for a valuation exposure? If not, what other approach could be prescribed? Explain your reasoning.**

We reiterate our strong opposition to the use of unrealized gains concept.

More specifically, the proposed charge appears extremely punitive and beyond the range of reasonableness. HSBC would recommend that any fall back method be based on a fixed % applied to B&S metrics. Such % could and should be calibrated on and extrapolated from observed AVAs that result from the core approach calculation.

**Q7. Do you agree with the approaches defined above to calculate AVAs for market price uncertainty, close-out costs, and unearned credit spreads? If not, what other approach could be prescribed? State your reasons.**

We are supportive of the general approach to ascertain uncertainties with the following caveats:

First, the distinction between cash and non cash exposures (“*For non-derivative valuation positions, or*

*valuation positions for which there is a directly observable price, the valuation input shall be the price of the instrument*.”) is artificial and inconsistent with greek-based risk management practises.

We believe that firms should be allowed to use a risk-based approach for cash products as well (notably bonds), in accordance with Article 8 (“*where portfolios of instruments are demonstrated to contain matching, offsetting assets and liabilities, AVAs are only required on any residual valuation exposures*.“)

Second, we agree that any risk reduction/portfolio projection techniques that are used for bid offer or AVA calculations should be supported by appropriate and robust documentation.

However, we find the proposed P&L volatility ratio testing overly prescriptive, unnecessarily limiting, and hardly applicable to less liquid/observable parameters for which daily prices are not easily retrievable: a typical example is the parameters that drive volatility surfaces (skew, smile).

We believe that risk netting/bucketing should be based upon expert judgement supported by quantitative and qualitative techniques such as:

* principal component analysis, which is a standard quantitative technique used to evidence the number of independent risk factors that drive a matrix of parameters (for example,, rates/spreads curves, volatility surfaces);
* existence of calendar/strike spread broker quotes that demonstrate ability to trade risk across buckets as a package at reduced bid offer;
* comparison of IPV versus bid-offer/AVA over time;
* analysis of risk points available in consensus IPV services or bid-offer buckets available in consensus bid-offer services.

**Q8. Do you agree with the approaches defined in Articles 11 to 16 to calculate the various categories of AVAs? If not, what other approach could be prescribed for each AVA? State your reasons.**

We agree that “*alternative modelling and calibration approaches*“ are amongst the possible approaches to assess explicitly model risk AVAs from a theoretical standpoint. Care should be taken to keep alternative assumptions realistic and reasonable. Over simplified or obsolete modelling should also be avoided when performing this exercise.

Alternatively, a common and practical approach may consist of analysing prices dispersion of relevant exotic products observed on consensus service and/or collateral. Consequently, model risk would be entirely captured through and reported under market price uncertainty.

We believe that **funding cost AVAs** for non strongly collateralized derivatives should be assessed over a reasonably conservative estimate of the effective lifetime of the portfolio. Calculation based on contractual lifetime may lead to unrealistic results. Also, calculation should not be performed by trade in isolation but at a portfolio level.

**Future administrative costs AVAs** should be limited to legacy/hard-to-exit portfolios and deemed irrelevant in respect of tradable products.

We reiterate that **operational risk** **AVAs** should be out of scope. Operational risk should be capitalised through the operational risk capital charge. There are operational risks associated with the measurement of all capital charges, and it is unclear to us why there would be explicit consideration of operational risk in the prudent valuation framework when this is not apparent in other capital charges (market risk, credit risk etc.). Finally, the proposed 10% charge is arbitrary and provides no incentive to improve the valuation framework

**Q9. Are there cases where the above AVAs may have a zero value that could be defined in the RTS? If yes, please specify.**

We do not see any benefit in specifying specific assets that would have a zero value.

We agree with the principle that liquid assets should have zero AVA.

AVAs should not be calculated for own credit spread and debit valuation adjustment exposures as they are already filtered from CET1.

**Q10. Do you agree with the approach defined above for the aggregation of valuation exposure level AVAs within the market price uncertainty and close-out cost AVA categories? If not, what other approach could be prescribed? State your reasons.**

We support the proposed level of diversification (50%) which looks consistent with the low level of correlation between uncertainties (25%) that one may observe from consensus data.

We recognise that some more sophisticated in-house approaches could be developed but this would likely introduce further distortion amongst firms and would unnecessarily complicate the calculation process. A flat multiplier seems therefore appropriate provided that it is not restricted to market price uncertainty and close out AVAs.

**Q11. Do you agree that category level AVAs described in Articles 11 to 16 within the core approach should be aggregated as a simple sum? If not, what other approach could be prescribed? State your reasons.**

We strongly believe that the diversification benefit should be extended to both **model risk** and **concentration AVAs**.

As stated in Q4, **model risk AVAs** exhibit strong commonalities with market price uncertainties. The logic, already accepted by EBA, that supports diversification benefit in market price uncertainty and close out AVAs applies equally to model risk AVAs.

In respect of concentration risk AVAs, the CP suggests VaR-like measurement techniques(**“***a prudent exit period shall be estimated and an AVA shall be estimated taking into account the volatility of the valuation input*”). One would therefore expect to observe a subsequent degree of diversification at firm level. Similarly, we also observe that the Fundamental Review of Trading Book (Annex 4) explores the possible integration of illiquidity risk into internal models and explicitly recognizes the role of diversification. Fair value is determined in the context of orderly unwind rather than fire sale, and consequently one would anticipate realisation of diversification benefit during the unwind period.

A technical argument should also be raised: a firm could ask a pool of dealers to bid for a concentrated exposure and be in a position to derive an exit price at a 90% confidence level. The resulting close out AVAs would be classified as market price uncertainty and subsequently subject to a 50% haircut as per Article 17. It is desirable to avoid any potential arbitrage across classification, and hence adopt a consistent diversification approach.

**Q12. Do you agree with the requirement for institutions using the core approach to implement the above ongoing monitoring tool as an indicator of the adequacy of data sources of valuation inputs used to calculate the AVAs described in Articles 8 to 10? If not, what other approach could be prescribed? State your reasons.**

We strongly disagree. The proposed methodology is confusing and ineffective as parameters variability over time would materially distort the results. Moreover, the proposed back testing would require massive architecture changes.

We advocate portfolio FVAs & AVAs benchmarking through consensus or regulators’ surveys: we observe that Basel has undertaken a benchmarking on internal model which includes FVAs and AVAs returns for a set of portfolios. On-going comparative analysis between IPV, Bid Offer and AVAs should also be considered as a practical alternative for reasonableness testing. Additionally, a robust and detailed P&L explain should be highlighting any remaining deficiencies. Finally, effective AVA’s corroboration is provided when examining collateral management data.

**Q13. Do you agree with our analysis of the impact of the proposals in this CP? If not, can you provide any evidence or data that would explain why you disagree or might further inform our analysis of the likely impacts of the proposals?**

We anticipate that significant systems modifications would be required to capture unrealized P&L (as per article 7 of the core approach). Material development would also be necessary to comply with the on-going monitoring tool (as described in Article 20) and perform the specific 100 days volatility measures testing (Article 8&9). As previously underscored, we have serious doubt regarding the benefit of such developments