

Sent by email to: EBA-DP-2012-03@eba.europa.eu

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Subject **EBA**: DISCUSSION PAPER ON DRAFT REGULATORY STANDARDS ON PRUDENT VALUATION

Reference No: EBA/DP/2012/03

13 January 2013

HSBC welcomes the opportunity to comment on the draft Regulatory Technical Standards (RTS) on Prudent Valuation.

HSBC Holdings plc, the parent company of the HSBC Group, is headquartered in London. The Group serves customers worldwide from around 6,900 offices in over 80 countries and territories in Europe, the Asia-Pacific region, North and Latin America, the Middle East and Africa. With assets of US\$2,721bn at 30 September 2012, the HSBC Group is one of the world's largest banking and financial services organisations.

HSBC recognizes that fair value is a neutral concept and does not systematically account for the extra degree of prudence required by Regulators. For example, both IFRS and US GAAP prevent the adoption of "block discounts" against certain positions.

HSBC welcomes the consistent development and application of regulation across jurisdictions, and therefore welcomes the lead that the EBA is taking in this matter.

HSBC agrees that valuation uncertainty should be holistically assessed, monitored and reported in a consistent fashion across industry participants.

However, HSBC has some concerns and observations in respect of the draft RTS;

- a) The utilisation of a very high confidence interval (i) does not reflect the fundamental nature of the uncertainty (ii) increases the measurement challenge and hence threatens comparability across institutions, and (iii) risks over-capitalisation by placing undue weight on lower quality data.
- b) It is critical that diversification benefits are allowed both to encourage risk diversification and prevent unfair penalisation of well diversified institutions.
- c) The RTS should avoid being overly prescriptive given that the subject matter is fundamentally judgemental and hence the application of judgement cannot be avoided, either by preparers or assessors.
- d) The proposed back-testing procedures are unnecessary for liquid positions, and likely to be ineffective for illiquid positions. HSBC believes that portfolio benchmarking exercises are both more effective and informative.
- e) Prudent valuation should focus on risk factors that directly and unambiguously drive fair value. Operational items should be capitalised within the operational risk charge.

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- f) Offsets should be allowed against other Pillar 1 charges where such charges are punitive, especially if the application of prudent valuation would lead to a position being more than fully capitalised. Prudent valuation should also be tax adjusted.

Further explanation in respect of these points, and other comments, are given in the answers below.

Yours faithfully

A handwritten signature in black ink, appearing to read 'Ed Jenkins', followed by a small dash.

Ed Jenkins
Head of Regulatory Advising and Accounting Policy
Global Banking and Markets

Annex 5 - Summary of questions

1. Do you believe that a proportionality threshold should be considered before requiring an institution to assess the prudent value of all fair value positions? If yes, how would you define the threshold?

This question could refer to one of two topics;

- (a) The establishment of a threshold below which an institution would not be required to complete a Prudent Valuation return or calculate an AVA. HSBC notes that institutions of any size may transact products that bear significant valuation uncertainty, and that best practice is to assess that uncertainty as part of the overall risk management framework. A proportionality threshold could require that an institution both falls below an absolute size, and that the institution has a risk management framework that considers valuation uncertainty.
- (b) The exclusion by an institution of certain fair value positions from the AVA on the basis of materiality, the so-called "materiality exemption" question.

HSBC believes that an optional materiality exemption would allow all parties to focus resource on material items, provided that the materiality exemption test was not itself as onerous as performing the AVA calculation.

For example, immateriality could be demonstrated in active two way markets that may then be excluded from the calculation.

A materiality threshold may be defined in absolute terms (e.g. an amount of capital equivalent) or in relative terms (e.g. % of total capital charge), both for individual excluded risks, and as an aggregate of excluded risks. Simplified calculations, demonstrably more prudent than the AVA calculation, could be used in the immateriality demonstration in some instances.

2. Do you agree that the exit price used as the basis of prudent value does not necessarily need to be based on an instantaneous sale? If yes, provide argument to support your view.

Yes.

The concept of instantaneous sale is not well defined: it is not a term commonly used either in accounting or in trading. Fair value reflects the best estimate of exit price at a given point in time and given market conditions, but does not require that the realisation of that fair value be instantaneous. The close out process may practically require some time, especially for more structured positions.

Trading exposures are already subject to a value-at-risk capital charge based on a ten days unwind horizon. An incremental charge for illiquidity makes sense for positions that require more than ten days to unwind. This is notably true where "block discounts" are prohibited by accounting rules, such as for large security positions traded in active markets.

As Trading Book rules evolve, maintenance of consistency between liquidity horizons within the market risk framework and prudent valuation framework is desirable.

3. Should a specific time horizon for exit be set when assessing the prudent valuation? If so, how the time horizon should be set (e.g. the same time horizon for calculating Value-at-Risk (VaR), Credit Risk Capital Requirements, etc.), what should it be and how would it feed into the calculating of AVAs?

It is not appropriate to set a single fixed exit time horizon for prudential valuation, if by this it is meant a fixed time period over which an asset disposal should take place.

Instead, as outlined in the response to question 2, HSBC believes that it is appropriate to establish a liquidity horizon such that if the disposal of any position would require longer than the liquidity horizon, consideration is given to a liquidity/concentration AVA. HSBC believes that, for consistency with the market risk framework, a liquidity horizon of 10 days would be currently be appropriate. However, any overlap with IRC should be considered.

4. Do you support the concept of a specified level of confidence to determine AVAs? If not, why? Are there any AVAs where the use of a specified level of confidence is not appropriate?

HSBC supports the concept of a specified level of confidence to determine AVAs, as this promotes consistency and a "level playing field" amongst firms.

As outlined in our response to question 12, HSBC believes that there are certain proposed components of the AVA which should not be part of prudent valuation. The confidence level concept is not applicable at position level when it comes to quantifying valuation issues related to balance sheet substantiation and operational risk.

5. If you support a specified level of confidence, do you support the use of a 95% level of confidence? What practical issues might arise or inconsistencies with other parts of the CRR when using this level of confidence?

HSBC does not support a 95% level of confidence.

In reaching this conclusion, HSBC makes a number of observations;

- (a) The nature of the uncertainty being assessed within prudent valuation is fundamentally different from that being assessed through many other regulatory capital calculations. Many regulatory capital calculations are assessing uncertainty associated with future events, which are fundamentally unknown, and therefore potentially unbounded. Prudent valuation is assessing uncertainty in a current valuation distribution, some of which may not be visible to the assessor, but which fundamentally exists and is bounded. It is not therefore necessary to apply the higher levels of confidence common in other regulatory capital calculations.
- (b) As EBA has recognised on page 6 of the discussion paper, a higher confidence level increases the measurement challenge, because it forces assumptions about that part of the distribution (the tail) where there is the least information. HSBC believes that it is important that there is a "level playing field" between firms. HSBC believes that the prudent valuation framework has the potential to increase discrepancies between firms, as those firms that take a more aggressive approach to fair value determination may also be more inclined to take a more aggressive approach to prudent value. In this context, HSBC believes that adoption of a lower confidence interval that more readily facilitates comparability is critically important.
- (c) Adoption of a very high confidence interval may further lead to over-capitalisation. Outliers in the pricing distribution may reflect a lower quality of price, for example representing stale prices or prices provided by market participants that have no or little risk exposure and therefore have not applied high levels of diligence to their price submissions. Adoption of a high confidence interval risks giving undue weight to such prices.
- (d) FSA regulated firms have already developed methodologies that target a 90% confidence interval. HSBC believes that one standard deviation would be a statistically reasonable measure of expected uncertainty, commensurate with a one-tail 85% confidence level.

6. How prescriptive do you believe the RTS should be around the number of data points that are required to calculate a 95% level of confidence without any more judgemental approach being necessary?

As stated above, HSBC does not support a 95% confidence interval. Regardless, HSBC does not believe the RTS should specify a minimum number of data points required before a more judgemental approach is required, no matter what the level of confidence adopted. There are several reasons for this;

- (a) Any calculation will require a degree of judgement. For example, assumptions are necessary regarding the distribution of underlying data (Gaussian law, uniform law...). Specification of a minimum number of data points encourages application of a mechanical calculation with no judgemental overlay.
- (b) Materiality is an important consideration. A mechanical calculation may be appropriate, even if the number of data points were below the limit, where positions are immaterial (although note that HSBC supports the adoption of a materiality exemption, per response to question 2).
- (c) Complexities will arise in the interpretation of a limit. For example, if the number of data points available across a volatility surface were in excess of the limit, would it then be appropriate to apply the mechanical calculation, even if there were parts of that surface for which no data was available at all ?
- (d) The establishment of a limit may encourage the use of solely judgemental approaches where that limit is not met, even though there would still be value in applying more quantitative techniques. For example, techniques exist to infer dispersion even where a small set of sample data is available.

7. If you support a specified level of confidence, do you support the explicit allowance of using the level chosen as guidance for a more judgemental approach where data is lacking

Yes. There should be internal consistency in the calculation and across firms. It is rare that there is no data at all from which to compute uncertainty. In the vast majority of cases there is some data and some quantitative techniques that can be used to assist in uncertainty determination. A specified confidence interval is helpful for the application of these techniques, even if it is also important that a judgemental overlay be applied.

8. Should any additional possible sources of market prices be listed in the RTS?

Firms should be allowed to consider any relevant market sources or valuation techniques. RTS should not be limiting in that respect.

9. Should more description be included of how to use the various sources of market prices to obtain a range of plausible prices?

An indicative description may be useful for smaller participants but should not be limiting nor binding for more sophisticated banks. These should be given in an appendix rather than in the main text.

10. Should the RTS be more prescriptive on how to use the various alternative methods or sources of data to obtain a range of plausible prices where there is insufficient observable data to determine the range by direct statistical methods? If so how?

No. Indicative examples are welcome but regulators should recognize that a range of alternative

techniques may be used. Further approaches may be designed and developed as markets infrastructure evolves

11. Are there any other indicators of large market price uncertainty which should be included?

Turn-over analysis applied to risk factors can highlight potential market illiquidity.

Persistent disputes /valuation dispersion observed in collateral management may be also informative.

12. Do you believe the approaches set out above are appropriate for each of the adjustments listed in Article 100? If not, what approaches do you believe would be more relevant?

HSBC believes that some of the adjustments listed in Article 100, or the discussion paper in the case of balance sheet substantiation, are not relevant to a prudent value determination.

Specifically, these are;

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.)

Balance sheet substantiation is an operational process unrelated to a determination of valuation uncertainty and should also be considered in the operational risk capital charge. Further, it is outside the scope of Article 100.

HSBC has the following additional comments;

(a) Early termination based on client unwind statistics is potentially biased as i) it ignores any profits derived from trade restructuring, and ii) it does not capture the on-going flow of new trades.

(b) Full revaluation should be limited to highly convex portfolios. The degree of accuracy required for AVA should not exceed that already adopted in the IPV or FVA processes.

13. Are there any other material causes of valuation uncertainty that the RTS should describe an approach for? Or are any of the adjustments listed above not material and should not be included?

HSBC is of the view that valuation uncertainty should be limited to the range of pricing choices at a given point in time and should not attempt to encompass non tradable risks or events. As stated in the response to question 12, HSBC believes that operational risk and balance sheet substantiation are not relevant to valuation uncertainty.

14. Do you believe that the testing approach in Annex 2 represents a useful tool to test for prudence of valuation? If not, what weaknesses make it unsuitable?

Sophisticated financial institutions should already adopt a comprehensive valuation control framework including controls such as p&l analysis and off market rate checking that would be expected to highlight material p&l on trade execution or unwind, and consider the appropriateness of the fair value framework in light of this on an on-going basis.

In that respect, the proposed testing looks unnecessary. In addition, it is overly prescriptive, cumbersome, model dependent and artificially scientific. Back-testing results would also likely be polluted by intraday volatility and portfolio netting effects and therefore prove hard to interpret.

In respect of the most illiquid positions, backtesting approaches may also be ineffective as a result of bias. Institutions tend to unwind at a profit, but to prefer further risk management in preference to sale at a loss.

The testing would require significant resources that would be better directed to tackling key valuation issues. HSBC is doubtful that a cost/benefit analysis would support the introduction of back testing.

In light of the above, HSBC believes that regular portfolio benchmarking, as previously conducted in some cases by FSA or as recently introduced by consensus pricing providers, is a more effective and informative methodology for assessing AVA calculation.

15. Do you believe that the RTS should be prescriptive with respect to validation techniques? If not, how do you believe that comparable levels of prudence should be ensured for the valuations across institutions? Are there other validation techniques that you believe should be detailed in the RTS?

Please see response to question 14.

16. Do you support the concept that prudent value can never be greater than fair value including fair value adjustments at both the individual position and the legal entity level? If not, what would be the reason to justify your view?

HSBC does not agree with this view, for two reasons;

- (a) Prudent valuation is defined at a given confidence interval. For example, if it were defined at a confidence interval of 90%, this would imply that there is a range of potential fair values in the market, 10% of which lie below the prudent value. It is then inconsistent to argue that prudent value must always be in excess of fair value.
- (b) IFRS retains the concept of "day 1 p&l reserves", and these are part of the accounting fair value. Such reserves are determined at inception of a transaction, and are not dynamically recalculated as the market moves. Consequently they can introduce a level of prudence in the accounting fair value that can result in the accounting fair value falling below the prudent value.

17. Would you support the availability of a diversification benefit within the aggregation of position-level AVAs? Please explain the reasons and justification why, providing any evidence available to support your arguments

HSBC believes that it is critical that diversification benefit is recognised within the aggregation, for the following reasons;

- (a) HSBC notes and supports the EBA's observations on page 6 of the discussion paper. Specifically EBA notes that "an institution with many different positions in different asset classes with small valuation uncertainties may face a very different total valuation uncertainty when compared to an institution with one large position with significant valuation uncertainty". HSBC believes that it is important that the capital framework encourages risk diversification and does not unfairly penalise a well-diversified institution.
- (b) Empirically, HSBC has examined price dispersion and observed, as one might expect, that price dispersion is significantly less than a simple sum of uncertainties derived at

position level. HSBC would be prepared to provide this analysis to EBA upon request.

- (c) The existence of portfolio diversification benefits is recognised in other capital calculations, and it would seem inconsistent not to recognise diversification benefit in prudent value.
 - (d) Any concerns regarding a systemic bias within any particular institution that may lead one to question the diversification benefit claimed by that institution are best dealt with by application of additional charges against that institution, rather than adoption of a punitive framework for all.
18. If simple aggregation better reflect your assumptions and practices or would you support the availability of diversification benefit, do you support creating a simplified standard approach, an example of which is shown in Annex 4? If you do, do you have alternative suggestions on how this standard approach should be specified? Are the suggested correlations in the example appropriate, if not what other values could be used?

HSBC would support a simplified standard approach as an optional alternative to in-house expertise, but not a mandatory simplified standard approach. While consistency is desirable, over-simplification may lead to an unreasonably punitive AVA, especially for large institutions that operate across a number of asset classes and geographies.

HSBC's current view is that inner correlations of uncertainties between risk types within a given asset class are generally less than 75%, and outer correlations across asset classes are generally less than 25%.

19. If you support the availability of diversification benefit, do you support allowing an in-house approach which should be subject to approval by the regulator, an example of which is shown in Annex 4?

HSBC supports allowing in-house approaches, subject to regulatory review.

20. Would you agree that offsets against AVAs for overlaps with other Pillar 1 capital requirements should not be permitted? If not, what offsets might be appropriate and under what conditions might they be allowed (e.g. individually assessed by the institution and agreed with the regulator rather than specified in the RTS)?

HSBC does not agree that there should be no offsets for overlaps with other Pillar 1 requirements. In particular, offsets should be allowed where punitive treatments are adopted elsewhere in Pillar 1, especially where a position is already fully capitalised, or application of prudent valuation would cause the position to become more than fully capitalised. Securitisation rules are an example of this.

In addition, HSBC believes that it is appropriate to tax adjust the prudent valuation calculation. This follows from the observation that if the prudent value were to be realised into p&l, the actual impact on capital would be post tax.

21. Do you believe the above requirements are appropriate? If not, what other requirements could be necessary and what requirements stated above are considered not to be relevant?

Please see responses to other questions.

HSBC also believes that it is important the scope of the AVA is clarified. HSBC believes that the appropriate scope is fair valued positions within scope of the regulatory consolidation, and not fair valued positions outside of this, for which alternative regulation may apply.

22. What would be the sources of costs and benefits of requiring (a) the implementation of a unique AVA methodology and (b) a consistent format for reporting AVA? Do you agree that the benefits of such requirements outweigh the costs associated with them?

The proposed methodology exhibit a level of complexity that would require significant resource allocation, notably in terms of back testing production and analysis. The implementation of a rigid and prescriptive approach will also be detrimental to the exercise of sound judgement

23. If you agree with a reporting form being introduced, could you please provide a suggested template?

A template already exists for FSA regulated firms that could be marginally refined. Regulators should aim at homogenizing and unifying reporting templates

It is essential that the reporting granularity reflects or easily ties back to business organization and risk management practice so that reported numbers are effectively monitored, reviewed and compared to other financial metrics.

The distinction between mark to market and mark to model is to some extent artificial and adds a layer of unnecessary complexity.

