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European Banking Authority
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Dear Sirs

Discussion Paper on Technical Advice to the Commission on possible treatments of unrealised gains measured at fair value under Article 80 of the Capital Requirements Regulation (CRR)

HSBC welcomes the opportunity to respond to the EBA's Discussion Paper ('DP') Technical Advice to the Commission on possible treatments of unrealised gains measured at fair value under Article 80 of the Capital Requirements Regulation (CRR).

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.

We are generally supportive of the move towards global harmonisation of regulatory regimes that will be achieved through implementation of the Basel III framework. For this reason it is very important that EU regulation does not pre-empt possible later changes to the Basel III framework and we are therefore concerned about the proposals in this DP.

While we understand the EBA's concern about the capacity to realise items included in Common Equity Tier 1 ('CET1') we believe that the proposals are not sufficiently well aligned with all the elements of the overall regulatory framework. This framework includes liquidity requirements, regulation of the trading book and the EBA's Draft RTS on prudent valuation under Article 105(14) of Regulation (EU) 575/2013 (Capital Requirements Regulation – CRR) ('PVA framework') which will be applicable to all financial instruments measured at fair value: the inter-connections with these elements of the regulatory framework should be considered in the context of these proposals.

The PVA framework specifically introduces prudential soundness as a concept and addresses capital requirements for fair valued positions. It also introduces asymmetry to the regulatory treatment of unrealised gains and losses and if any additional regulatory adjustments to unrealised gains and losses were deemed necessary they should therefore be symmetric to reflect the way banks balance their risks and to avoid the unnecessary build-up of artificial volatility in capital.

Apart from our general concern about the overlap with other regulatory requirements we believe that the EBA is interpreting the scope of the technical advice required under article 80 of the CRR too widely. It is our reading of the regulation that the scope of the DP should be limited to unrealised gains measured at fair value that are recognised in other comprehensive income ('OCI') and those on investment properties that are recognised in P&L; therefore all accounting

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and regulatory trading book items and items measured at fair value through P&L in the regulatory banking book would be excluded from the scope of the DP.

Against this background, our key concerns are summarised below; more detailed answers to the questions in the DP are included in Appendix I.

- We agree with the Basel III framework and the current rules of CRR that no adjustment to remove unrealised gains or losses recognised on the balance sheet from CET1 should be applied¹. While we understand that the appropriate treatment of such unrealised gains will continue to be reviewed taking into account the evolution of the accounting framework, we do not believe that there have been any developments since issuance of the Basel III framework in December 2010 that would justify a review at this point in time.
- We do not support the introduction of a capital filter ahead of any changes to the Basel regulatory framework as this would widen global divergence of regulatory regimes rather than support the path to a harmonised global framework.
- We believe that trading book items and items designated at fair value through P&L in the banking book should be excluded from the scope of the DP.
- One of the key prudential concerns addressed in this DP is the reliability of fair values underlying the unrealised gains recognised in CET1. However, the reliability of fair values is already addressed by the PVA framework. The proposals contemplated in this DP would therefore result in a fundamental overlap and double counting. It is important that any final rules to further incorporate an adjustment for this element are embedded in a cohesive framework, avoiding any double counting and being consistent with the requirements of the liquidity framework.
- The PVA framework already introduces asymmetry to the regulatory treatment of unrealised gains and losses. Any regulatory treatment of unrealised gains and losses on top of any PVA adjustment should therefore be symmetric reflecting the way banks balance their risks, with fluctuations in value largely cancelling each other out. For positions measured at amortised cost this risk management is naturally reflected in capital as no value adjustments occur. By introducing a filter for unrealised gains measured at fair value, but retaining unrealised losses in capital, the balancing effect of banks' risk management would be ignored and banks would effectively be penalised for accounting for items at fair value rather than at amortised cost. This one sided approach would cause procyclical effects and distort the capital position. We are therefore concerned that the DP only analyses options which constitute an asymmetric filter, with no recognition or partial recognition of unrealised gains, that will cause volatility in capital. In our view this overstates bank risks and does not reflect true capital movements.

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

Yours sincerely,

Russell Picot

¹ Basel III framework, paragraph 52, footnote 10 and article 35 of the CRR



Appendix 1

1. Do you agree with the scope of the discussion paper for the technical advice? Are there other elements that should be covered? If yes, please state why

We do not agree with the EBA's interpretation of the scope for the technical advice. The EBA bases the scope for the discussion paper ('DP') on its interpretation of article 468 of the CRR and concludes that this article refers to unrealised gains arising within both profit or loss ('P&L') and OCI on items held as at the reporting date.

It is our understanding that article 468 relates solely to unrealised gains measured at fair value that are recognised in OCI and those on investment properties that are recognised through P&L. This view is supported by the fact that article 468 is part of the transitional provisions of the CRD and relates to the removal of the capital filter for unrealised gains measured at fair value; neither current rules nor CRR rules include a capital filter for unrealised gains measured at fair value that are recognised through P&L other than those on investment properties. Our reading of article 468 is also supported by the original Basel III text which only refers to a review of the appropriate treatment of unrealised gains in relation to OCI and other disclosed reserves.

Based on the above analysis we believe that the scope of the DP should be limited to unrealised gains measured at fair value that are recognised in OCI and those on investment properties that are recognised in P&L; therefore all trading book items and items measured at fair value through P&L that are outside the trading book would be excluded from the scope of the DP.

We also believe that the PVA framework, on which the EBA is currently consulting needs to be taken into account in any consideration of a prudential filter on unrealised gains. As per article 105 of the CRR the aim of the PVA framework is to determine a prudent value that achieves an *'appropriate degree of certainty having regard to the dynamic nature of trading book positions, the demands of prudential soundness and the mode of operation and purpose of capital requirements in respect of trading book positions'*. Article 34 of the same Regulation requires that institutions shall apply the standards of Article 105 to all assets measured at fair value. The above objective of a prudent value is therefore not limited to the trading book but extends to all financial instruments measured at fair value and should already address concerns about reliability and the capacity to realise of fair values.

2. Do you agree with the description of the different criteria provided on this section in order to assess the possible treatments of unrealised gains? If not, please state why. Do you think there are other criteria that should be considered?

We believe that any measures to address concerns about the loss absorbency of unrealised gains need to be anchored within a consistent prudential framework, taking into account other measures which are already or will soon be in place. As noted above, in our view any concerns about the reliability of and the capacity to realise fair value are addressed by the PVA framework, on which the EBA is currently consulting, given that the scope of the framework includes all fair value measurements of financial instruments on the balance sheet, i.e. it includes banking book as well as trading book items.

We also believe that the interaction with other regulatory requirements should be taken into account when considering this policy issue. In our view any adjustments to unrealised gains should be carefully considered in the context of the liquidity framework. We are concerned that most assets held for the purpose of liquidity management are currently held in the available for sale category and would, under the proposed changes to IFRS 9 Classification and Measurement, continue to fall into an accounting category where fair value movements are recognised in OCI. Liquidity ratios proposed by the Basel Committee rightly encourage banks to hold good levels of liquid assets to ensure financial stability and it is by definition most straightforward to liquidate these liquid assets. It would therefore appear counterintuitive to remove unrealised gains on such assets from CET1 on the grounds that the unrealised gains may not be realisable.

Even for items outside the liquidity portfolio we do not accept the concern about unrealised gains. While the DP correctly points out that any fair value gains on a debt security held to maturity will reverse over its lifetime, this would not stop it from being sold to realise profits in order to absorb losses when needed even if a security was originally held with the intention to collect the contractual cash flows.

3. Do you agree with the proposed approach based on the prudential classification (distinction between the trading and banking book) to analyse the different policy options? If not, please state why. Do you envisage any operational issue if the prudential approach is followed?

We do not agree with the proposed approach to analyse the different policy options based on the prudential classification. As outlined in our response to question 4 the accounting classification of held for trading and the regulatory trading book do not always align which can cause problems if a filter is based on either accounting or regulatory classification. For example, a derivative held as part of an economic hedge would be part of the regulatory banking book but measured at fair value through P&L for accounting purposes. As noted above it is our understanding that financial instruments measured at fair value through P&L should be out of scope for the consideration of a prudential filter on unrealised gains and the proposal should only consider unrealised gains recognised in OCI. Such an approach would make the question of accounting or regulatory classification superfluous.

There are also practical considerations supporting the above approach. Fair value movements recognised in OCI accrue over time and OCI therefore shows life to date reserves. However, unrealised gains recognised in P&L are year to date figures. This could result in adjustments to reserves which do not truly reflect unrealised gains arising from individual instruments. If, for example, an unrealised loss on an instrument is recognised in P&L in year 1 and this loss reverses in year 2 a prudential filter on unrealised gains recognised in P&L would filter out the gain in year 2 even though the instrument has merely recovered its original value. The unrealised loss recognised in the prior year would be part of retained earnings. For items which are measured at fair value through P&L for accounting purposes it would be very difficult to track life to date unrealised gains in order to address this problem. If our above noted comments were ignored and a prudential filter on unrealised gains recognised in P&L was introduced we would require further explanatory guidance on how the filter should be applied, taking into account the issues raised above.



4. Do you have instruments that are classified as held for trading for accounting purposes included in the (regulatory) banking book or available for sale instruments classified as a position of the (regulatory) trading book? Could you quantify the relevance of these situations?

HSBC holds financial instruments that are classified as Held For Trading ('HFT') for accounting purposes but are part of the banking book for regulatory purposes. Similarly situations occur where instruments are held outside the HFT category for accounting purposes but are part of the trading book for regulatory purposes. We note that allocations between the trading and banking book may well need to be revisited after the Basel Committee's deliberations on the trading book.

The reason for the seeming inconsistency between accounting and regulatory categories lies in the different rule sets. For accounting purposes an instrument is classified as HFT at initial recognition if it is acquired or incurred principally for the purpose of selling or repurchasing it in the near term, it is part of a portfolio of financial instruments that are managed together and for which there is evidence of recent actual pattern of short-term profit taking, or it is a derivative. Generally, once classified into this category the financial instrument will remain in that same accounting category until it is sold or matures even if the original reason for the classification, e.g. short-term profit taking, changes.

For regulatory purposes 'trading intent' is a key factor in classifying a financial instrument between trading and banking book. Derivatives used for hedging, e.g. of the interest rate risk in a bank's treasury or lending books, do not meet the 'trading intent' criteria and are therefore held in the banking book for capital purposes. In addition, an instrument will change its regulatory position from trading to banking book or vice versa where there is a change in the 'trading intent'. This could be the case where the trading strategy moves from 'trading intent' to Available for Sale (AFS) or buy to hold or from AFS to actively seeking short-term profit with marking to market. An example for the latter could be the transfer of lending positions into distressed debt trading. However, it is generally rare for positions to transfer between trading and banking book or vice versa and for HSBC derivative hedges in the banking book make up only a small proportion of the overall portfolios measured at fair value.

5. Do you see any differences in the analysis that should be taken into account with the requirements in the forthcoming IFRS 9?

As highlighted in question 2 above, we believe that the currently proposed third measurement category in IFRS 9 (Fair value through OCI - FVOCI) would result in most assets held for liquidity management purposes being classified into this category. We would be very concerned if unrealised gains on such assets would be excluded from CET1 on the grounds of concerns about the capacity to realise them or concerns about the fair value measurement as this would be inconsistent with the liquidity framework requirements.



6. Do you agree with the proposal to distinguish between different categories of instruments/items (interest bearing financial instruments, non-interest bearing financial instruments and tangible assets) in analysing the different policy options? If not, please state why

We do not fully agree with the proposal to distinguish between different categories of instruments/items in analysing the different policy options.

In our view all prudential concerns about the reliability of and the capacity to realise fair value measurement of financial instrument are addressed through the PVA framework, i.e. we do not see a need for a prudential filter for unrealised gains on such instruments, independently of whether the instruments are interest bearing or not.

We understand that a separate analysis is required for tangible assets as they fall outside the scope of regulatory requirements for financial instruments and are not captured by the PVA framework.

7. Do you agree with the arguments in favour of an item-by-item basis or a portfolio basis? Are there other arguments that should be considered for the decision to apply the policy options on an item-by-item or on a portfolio basis?

We agree with the arguments in favour of both approaches brought forward in the DP.

However, we believe that the arguments in favour of a portfolio approach weigh much heavier as it reflects current risk management practices and encourages diversification as opposed to an item-by-item approach which would incentivise banks to sell and buy back assets in order to realise unrealised gains.

Therefore, if a new filter were to be introduced we believe it should applied on a portfolio basis in line with current risk management practices and consistent with the current filter. We would also be concerned about the operability of an item-by-item approach.

8. Do you consider that the application on an item-by-item or on a portfolio basis would be more justified for certain types of instruments/items than for others (for instance, debt securities, equity instruments, tangible assets)?

We do not believe that any type of financial instrument would require an item by item approach and we note that such an approach would not reflect a bank's risk management approach.

For tangible assets it might be necessary to apply an item-by-item approach as institutions might not commonly hold portfolios of sufficiently similar tangible assets to apply a portfolio approach. However, we do not see any reason why an item-by-item approach should be required if institutions do hold such portfolios.

9. Please provide quantitative information about the difference between applying a filter on a portfolio basis or on an item-by-item basis and the impact of this difference in your capital ratios.

We note that there is currently no general requirement under accounting or regulatory rules to measure unrealised gains on an item-by-item basis. Furthermore, the EBA has not provided a definition of ‘unrealised gains’ and the term is open to interpretation. In addition, our risk management approach is based on portfolios so there also is no internal need for capturing the necessary data for an item-by-item approach. It is therefore currently not possible to quantify information about the difference between applying a filter on a portfolio basis or on an item-by-item basis.

However, there will be a significant difference depending on whether unrealised gains are measured on an instrument by instrument basis or on a portfolio basis. This difference is for example indicated by HSBC’s derivative disclosures, where gross fair value of derivatives assets as at 31 December 2012 were US\$730bn and of liabilities were US\$(731)bn, whereas the net was US\$(1)bn².

We note that banks generally recognise earnings based on a portfolio approach. Such earnings form the basis for distributions as well as the valuation of an institution. An adjustment to the capital base on an item-by-item basis would distort the valuation of an institution and it would be important that such changes to regulation would only be introduced on a global basis.

10. Do you agree with the alternatives presented in this section? Do you have a preferred alternative? Please explain the reasons.

We do not agree with the alternatives presented in this section. In our view, if a prudential filter were deemed to be necessary it should be applied symmetrically, i.e. excluding unrealised gains and losses at fair value. It is conceptually inconsistent to argue that certain unrealised gains, e.g. on debt securities, should not be included in capital because they will reverse over time while unrealised losses on the same instruments are at the same time included in capital.

Out of the alternatives presented we believe that a partial recognition approach would be the preferred alternative. However, the outlined concept of a haircut followed by a limit appears overly complex with the haircut seemingly topping up any PVA already applied to the instrument and therefore lacking any conceptual basis. Given that the concern seems to be linked to the overall percentage of capital being made up of unrealised gains, it appears easier to limit the percentage of CET1 that can be made up of unrealised gains.

We do not believe that unrealised gains should be excluded from CET1 and only included in AT1 or T2 as this would result in further asymmetric treatment given that unrealised losses are recognised as part of CET1.

² HSBC Holdings plc, Annual Report and Accounts 2012, page 452.

11. Do you agree that the haircut may be different depending on whether it affects the different layers of capital and also on whether the adjustment is applied on a portfolio or an item-by-item basis? Do you have a view regarding the level of the haircut?

As outlined above, we do not agree with the concept of a haircut as we cannot see a conceptual basis for a haircut on top of PVA. It is unclear what such a haircut would signify and it seems that it would make partial recognition unnecessarily more complex. However, if a haircut were deemed to be necessary, it should be applied on a portfolio basis.

12. Regarding the second adjustment (the threshold): do you agree to establish a limit to the recognition of unrealised gains in own funds? Do you have a view regarding the level of the threshold?

As outlined above, we do not believe that concerns about unrealised gains at fair value outlined in the DP would justify the introduction of an unbalanced filter. We do not have a view regarding the level of the threshold as we believe that such a threshold would be arbitrary.

13. Do you think equity and debt securities should be subject to the same policy options / treatment? Do you agree with the reasons provided in this section about the difference between equity and debt?

We believe that equity and debt securities should be subject to the same policy options/treatment. As noted in our response to question 6 we believe that any concern about reliability of or the capacity to realise fair value are addressed by the PVA framework and therefore there is no justification for a prudential filter on unrealised gains.

14. Do you agree with the analysis for hedge accounting? Please provide quantitative information about the relevance of hedge ineffectiveness in hedge accounting

We agree that there should be a consistent treatment of unrealised gains and losses of instruments in a hedging relationship, i.e. if unrealised gains on a hedged instrument are subject to a filter, the unrealised losses of the hedged item should be subject to the same filter and vice versa. This is also in line with our overarching view that there should be a symmetric treatment for all unrealised gains and losses, not only for those related to hedge accounting relationships.

The DP proposes that hedge ineffectiveness should be treated in the same way as unhedged risks. Hedge ineffectiveness for the HSBC Group at the last three year ends has ranged from US\$38m to US\$(224)m for fair value hedges and from US\$35m to US\$(9)m for cash flow hedges³.

We note at this point that the analysis in the DP does not include an analysis of economic hedges which constitute an accounting asymmetry. These are typically interest rate derivatives used to hedge interest rate risk or credit derivatives to hedge credit risk in the banking book which are fair valued as trading instruments whereas the economically hedged asset is not. In this instance we would be supportive of a prudential filter that addressed the asymmetry by removing both unrealised gains and losses.

³ HSBC Holdings plc, Annual Report and Accounts 2012, page 36.



15. Do you see any difference in this analysis under the forthcoming hedge accounting requirements that the IASB is expect to publish in the second half of 2013?

We do not believe that the forthcoming hedge accounting requirements would change the analysis as the principles of special designation, focus on in-effectiveness and accounting models do not change in IFRS 9.

16. Do you agree with the analysis for fair value option accounting? Do you classify assets and liabilities managed on a fair value basis and financial instruments with embedded derivatives in the banking or the trading book? Please state the reasons for the classification

In line with our overarching view that there should be symmetric treatment of all unrealised gains and losses we agree that there should be symmetric treatment for unrealised gains and losses for instruments designated at fair value under the fair value option in order to eliminate accounting mismatches.

17. Please provide quantitative information about the use of the fair value option

There is no regulatory or accounting requirement to track information about the use of the fair value option in the level of detail requested in the DP. We therefore cannot provide the requested data at this point. However, we note that for balances included in our regulatory consolidated balance sheet the main reason for the use of the fair value option is to address accounting mismatches.

18. Do you agree with the description provided in this section? Can you quantify the amount of unrealised gains included in the trading book?

We agree with the description provided in this section and particularly with the proposal to exclude trading book items from a potential prudential filter for unrealised gains as:

- the trading book is based on 'trading intent' and gains will generally be realised within a short timeframe and available to absorb losses;
- the risk of market price volatility is covered by the capital requirements for market risk; and
- the PVA framework addresses the reliability of and the capacity to realise fair value of all financial instruments measured at fair value.

We also agree that it would be operationally difficult to identify unrealised gains from realised gains.

Please see our response to question 9 regarding quantification of unrealised gains included in the trading book.



19. Do you think that there is a risk of double effect when applying a prudential filter and the requirements on prudent valuation?

We agree that there would be double counting if reliability of fair value is a consideration in the determination of a prudential filter for unrealised gains measured at fair value.

As outlined in our comments above, the PVA framework in our view addresses all concerns about reliability of fair value of financial instruments, whether they are in the trading book or banking book. We therefore do not believe that reliability of fair value should be a consideration in the treatment of unrealised gains measured at fair value.

20. Which are your views on the different issues described in point a) to d) of section 5.6.4? Please provide reasoning supporting your response

As outlined above, in our view no prudential filter addressing valuation uncertainty or the capacity to realise fair value is required as these uncertainties are already addressed by the PVA framework and accordingly there should be no remaining uncertainty about unrealised gains measured at fair value.

We believe that any filter would need to take PVA into account to avoid double counting. Furthermore, in order to achieve a symmetric and consistent treatment, unrealised gains should be recognised in CET1 as this is where unrealised losses are deducted and where PVA are adjusted.

21. In case a prudential filter is applied, do you agree that unrealised gains on investment property and property, plant and equipment measured at fair value should not be included in own funds? If not, please state why

As noted above, we are supportive of the move towards global harmonisation of regulatory regimes that will be achieved through implementation of the Basel III framework. We therefore believe that it is paramount that the CRR does not pre-empt possible later changes to the Basel III framework to continue on this path.

If changes were made to the Basel III framework, we would not object to a symmetric prudential filter for unrealised gains and losses on property, plant and equipment. Any unrealised gains/losses on such assets could not be realised in the short term given that they are part of the infrastructure that provides the support to enable trading/operating activities to be undertaken. Such assets are not used to generate revenues directly through their disposal/rent as part of normal business activities.

However, investment property measured at fair value through P&L is part of an entity's ongoing trade and normal business activities. Unrealised gains on such assets could be realised by sale of the property without impacting other business activities. We therefore do not believe that a prudential filter should be applied to unrealised gains on such assets.



22. Do you think that there are more reasons to apply a filter on an item-by-item basis for tangible assets (investment properties or property, plant and equipment) than for the investment portfolio classified in the banking book? What would be the rationale to apply a prudential filter on a portfolio basis for tangible assets?

As noted in our response to question 8, we believe that it will not be common for institutions to hold portfolios of investment properties or property, plant and equipment of sufficiently similar nature to allow valuation on a portfolio basis; an item-by-item approach might therefore be necessary. However, if institutions hold such portfolios we cannot see any reason why an item-by-item approach should be required.