HSBC

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I am writing in response to your consultation document issued in July 2011 on "FSB Consultative Document: Effective Resolution of Systematically Important Financial Institutions".

OVERVIEW OF FSB PROPOSALS

At HSBC, we are convinced that recovery and resolution plans will have a key role in any effective regulatory and policy framework designed to improve financial stability and ensure the sustainable supply of credit to the global economy.

We have been fully involved in the pilot study undertaken in the UK under the auspices of the FSA and the Bank of England. Their consultation document sets out a very comprehensive approach to Recovery and Resolution Plans and we will be providing them with detailed comments in due course. This has been a very valuable exercise not only for the elements which are directly relevant to the UK but also more widely across the HSBC Group. Above all, it has highlighted the need for international cooperation on this topic and so it is very encouraging to see the FSB taking a leading role in this.

HSBC has contributed to the papers submitted by industry bodies on this consultation but, given the importance of this topic, I felt that it was important that we provide a separate letter highlighting a number of areas of particular relevance to this Group, particlarly relating to our group structure and funding model.

RECOGNITION OF CORPORATE STRUCTURES

The consultation document recognises that there are a variety of corporate structures within institutions across the world including the use of financial and non-financial subsidiaries and domestic and international branches. This is a useful starting point but regulators need to delve more deeply into these structures to understand the links between these entities and branches which are relevant for the purposes of resolution.

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In some cases, individual elements are inextricably linked for example through comprehensive financial arrangements in areas such as liquidity, cash management, security and guarantees and inter-woven management, systems and operational structures. For groups so structured, a comprehensive and integrated approach to resolution is essential as no part of the group can go forward without assessing the impact on and from the others.

At the other end of the range of business models is a financial group comprised of a number of self-contained businesses, operating under central leadership in a co-ordinated fashion but with clarity and limitations on the links between the underlying banks. Although HSBC is not wholly subsidiarised around the world – in part, because of national legislation – this is a model which we tend to follow. We have a large number of separately capitalised banks with their own liquidity and funding pools, management teams and independent boards. The relationships between these banks and the rest of the Group are documented and are substantially on arms-length terms, without guarantees or cross-default arrangements. The majority of the subsidiary banks operate in only one geography; there are only five entities which have material overseas branches.

We believe that this geographically subsidiarised structure is a source of strength and stability, which helped HSBC weather crises well. Significantly, it is my firm conviction that our structure enhances our resolvability, particularly from a national supervisor's perspective, since the greater proportion of our risk is managed within individual jurisdictions, matched by local capital, funding and liquidity buffers but supported by the overall capital generating capacity of the HSBC Group. This comes at an accepted cost so it is important that, as the regulatory framework evolves, analysis is undertaken to determine the benefits from such a structure so that there are proper incentives for banking groups to adopt or retain more resilient and resolvable structures.

RECOVERY AND RESOLUTION PLANS

Group Structures

On the content of Recovery and Resolution Plans (as set out in Annex 5), our experience is that there needs to be a clearer distinction between recovery actions which are driven by the need to bolster capital ratios and those which principally relate to the continuing availability of funding and liquidity. This separation of capital and liquidity is particularly relevant to the HSBC Group given the corporate structure which is described above:

- For HSBC, significant decisions regarding capital allocation and external capital raising are undertaken at a holding company level. In the case of a capital recovery issue, there are local actions which can be taken, for example, in respect of asset growth and costs but it is the diversification of support available from the wider HSBC Group which will be critical to the recovery of an affected subsidiary institution.

- With respect to funding and liquidity, limited support can be provided by other Group members within normal, third-party style parameters and regulatory constraints on the extent to which inter-bank, cross-border and cross-currency facilities are possible. As a result, cash management issues are fundamentally the responsibility of local banking entities, which is why we have put in place long term funding structures and liquidity management programmes at local entity level as well as understand the facilities available from central banks within these local liquidity arrangements.

These are important distinctions which need to be recognised in the structure of Recovery and Resolution Plans for a group structured along these lines – it would be good to see a clearer expression of this in the final proposals.

This distinction between the holding company and local entities also flows across to resolution planning. Given our structure, although resolution would need a strong co-ordinating role at a Group level, we envisage that the detailed actions would be taken at a local level to address the impact on and of the specific institutions which have been affected by the resolution event.

Developing and Executing Plans

Our involvement in the recovery and resolution pilot in the UK has also highlighted two considerations for the development and execution of plans:

- As part of their development, there has to be a close working relationship between the normal regulatory supervisory team and the specialist team developing the recovery and resolution plans. Regulators already have an immense amount of knowledge and understanding of how individual financial institutions function and the benefits of that should not be lost by building RRPs from scratch. Wherever possible, regulators should rely on information which is already in the public domain or in submissions which are already made by firms on a regular basis. If these disclosures are insufficient, then these regular disclosures need to be improved to the requisite standard. We must avoid the development of two bodies of information if consistent policy and operational decisions are to be made. And clearly, optimal operational efficiency will require a well-defined, streamlined data set.

- Whilst resolution plans may ultimately be the responsibility of the regulatory authorities, they cannot be developed or implemented without the active involvement of the underlying institutions, particularly for SIFIs. It is not practical for authorities to operate on the basis of requiring banks to provide data and scenarios and then developing the plans in isolation – from the outside,

this has sometimes seemed to be the regulatory goal. Given the complexities of SIFIs, implementing such plans will require the active involvement of the residual management of any firm, albeit under the direction of the authorities. Therefore, they should be actively involved in the development of plans with the authorities so that they understand the scenarios for which they need to be prepared and instructions which they are being likely to be given.

Resolution plans also need to recognise the roles which are played by intermediaries and other counterparties such as central clearing counterparties, exchanges and payments systems. There needs to be an agreed understanding of how these will react in defined scenarios so that these can be built into contingency plans. This will also help banks understand the likely responses of the authorities if there is a failure of one of their peers and enable them to build their own response strategies accordingly.

Operating Contracts with Non-Financial Parties

There has been a discussion, particularly in the UK about the transfer of intra-group services to non-financial entities within the group, sometimes referred to as 'operational subsidiarisation'. We can appreciate the benefits of avoiding the contamination of operational services as a result of the financial failure of a 'host' bank. However, regulatory authorities should also recognise that their powers to intervene in non-financial companies are much more limited without specific regulation and the cross-border understanding which can be achieved between regulators of banks where there has been an intervention will be absent in discussion with the boards of directors of these entities and/or their administrators, if appropriate.

Banks also have contracts with non-financial firms for products and services essential to the on-going operation of banks, for example electricity, property services, basic software or financial data. These contracts may well be terminable when a bank is in resolution and we believe it will be difficult for individual banks to seek necessary changes to the standard terms from major commercial organisations, particularly cross-border, to avoid such an event. This is an area where clear direction from the FSB, the G20 and underlying governments would be of value, setting minimum requirements to 'resolution proof' supplier contracts which could be adopted as an industry standard by banks and their suppliers alike.

Intra-Group Transactions and Exposures

From the perspective of a group which is structured to have individually resolvable banking entities in many jurisdictions (as set out above), we see an apparent bias in the FSB's thinking against intra-group exposures (Section 4 of Annex 4 to your consultative document, on Resolvability Assessments). Seeking to apply standards to intra-group transactions that are higher than those applied to transactions with third parties is counterintuitive.

Intra-bank activity in the form of transactions such as loans, other credits and derivatives are essential to the efficient management of risk and liquidity and the provision of services to end-users. Within HSBC, where appropriate and largely within the guidelines which would apply to third party arrangements (including, for example, counterparty limits, documentation, security, pricing, collateral and margin calls) we prefer to enter into these deals between Group companies rather than introducing added complexity and transferring value unnecessarily outside of the HSBC Group.

In these circumstances, there is no clear rationale for resolution frameworks and, indeed, other regulatory requirements to penalise intra-group transactions as compared to those carried out with third party entities. There are other examples of this, for example, in the proposed Basel 3 liquidity framework which restricts the ability of international banking groups to provide liquidity support to an entity experiencing a liquidity stress from other group entities with excess liquidity positions. In our view, there should be symmetrical treatment of intra-group and third party inter-bank transactions where both provider and recipient are held to the standards which would apply to third party deals.

Bail-in within Resolution

We support the rationale for the bail-in of non-common equity capital at the point of non-viability being developed as a key resolution tool. It has a number of advantages, not least removing the potential for certain capital providers to be made whole if Governments or other parties determine that the best mechanism for resolving a bank is a significant injection of common equity.

In common with others, however, we see issues when bail-in is extended to senior debt. The FSB recognises that any debt write-down outside of an insolvency procedure must respect creditor hierarchy and the principle of "no creditor worse-off than in liquidation". However, to the extent that senior debt is identified for 'bail-in', this would be a distortion of the creditor hierarchy. The exclusion of certain types of senior creditor – swap, repo and derivative counterparties and other trade creditors, short term debt, deposits, secured debt and claims covered by master netting agreements – will necessarily create an un-excluded class of senior creditor that is subordinated. This, in turn, will create distorting impacts on bank funding structures (such as a mandatory requirement to issue senior subordinated debt) and potentially business models.

Ultimately, this will affect the demand for long-term senior debt and this effect could be compounded by the choice of "bail-in trigger". The depth of the investor base and cost will depend upon the remoteness and size of any potential write-down and clarity on these points is important.

There may also be some particular issues for the HSBC Group:

- Across the HSBC Group there has been a long emphasis on a conservative funding strategy, as demonstrated by a conservative loan-to-deposit ratio in all of the underlying legal entities. As a result, there are only a limited number of entities in the Group which raise public debt, with a significant tranche in our US consumer finance operations which are now being wound-down or sold. We believe it would be penal if banks which have created balanced deposit funded structures are forced to raise further funding for which they have no use and which can only be deployed in short term funding markets at a loss. This would seem to disincentivise prudence and I am sure that this is not a course the FSB wishes to take.

- Seeking to address this at a group level, particularly if a group basis for resolution is favoured by the authorities, has its own issues. There is only a modest level of senior debt at the holding company level which could be bailed-in; most debt funding is raised at a subsidiary level. The alternative would be for HSBC Holdings to raise debt and provide funding to the subsidiaries which require it creating a greater bail-in buffer at the group level. But this would be dilute the principles of separately resolvable legal entities operating mainly within single jurisdictions and would be a fundamental change in our successful funding approach. We would be reluctant to make this change.

- As a result of being under-lent to commercial customers, HSBC is a significant source of liquidity to the inter-bank market and it holds a large volume of inter-bank assets. We manage our credit exposures to these institutions carefully but we would have significant concerns about an extended bail-in regime, where this is seen as an early solution, rather than a last-resort.

The introduction of bail-in cannot be seen as a 'silver bullet' which would prevent taxpayers from being involved in any resolution of an institution. Bank debt is owned by pension funds and other bodies which ultimately represent the savings and investments of taxpayers. The authorities will need to think carefully about when such powers could be used without causing a secondary crisis, potentially more concentrated in its effects and without the ability to socialise the losses across the entire tax base. In these circumstances, the consequences could be severe but, at the same time, if the powers which have been taken are not used, questions of moral hazard would be raised again.

Capital levels, both in terms of core tier 1 and other instruments, have been significantly increased in the wake of the crisis and these should provide a more substantial buffer for regulators. If the powers to bail-in a class of senior debt are taken, it would be useful to have clarity about the 'last-resort' nature of bail-in so that the distorting effects are kept to a minimum. In particular, it would be important to clearly differentiate between the bail-in of Alternative Tier 1 Capital, Tier 2 Capital and "eligible" senior debt.

CONFIDENTIALITY

We support the importance awarded to confidentiality in the proposals. Given the increased demand for coordination and communication, it is critical that there is a very effective mechanism for regulators to share information and proposals without exposing the underlying firms to undue risks for either pre-emptive decisions or onward disclosure to inappropriate parties.

However, this will not be easy to achieve without appropriate structures and legislation being put in place at a local level to protect firms from disclosure under 'open government' or 'freedom of information' requirements or the inadvertent disclosure which may arise where the sensitivity of a particular piece of information is not seen across national boundaries. The FSB should be clear to the G20 that it has a collective and individual role to play in addressing this.

CONCLUSIONS

We believe that, in many instances, HSBC starts close to the place where the reforms want systemically important banks to end up – with higher capital ratios, a better funding structure, stronger liquidity and a simpler business model, further buttressed in the case of HSBC by virtue of operating through separately capitalised and funded legal entities which are capable of being separated if required. It is important that as the regulatory structures are put in place, the correct incentives are also developed to ensure that banking groups are encouraged to adopt or retain these more resilient and resolvable structures.

Yours sincerely

D J Flint