WRITTEN EVIDENCE SUBMITTED BY HSBC

RING-FENCING ALONG IFRS 9 AMORTISED COST CLASSIFICATION

Outline Proposal

The ICB recommends the ring-fencing of certain activities conducted by UK banks, but gives limited detail as to which activities should fall into which category. The following is a high level proposal which could be used to define the split with reference objectively and consistently amongst participants through applying the IFRS9 measurement criteria of 'amortised cost'.

Under this approach, the Ring-Fenced Bank (RFB) could be authorised to hold only assets which qualify for accrual accounting under IFRS 9 – the amortised cost classified activities.

Assets would therefore need to meet the following two criteria to be measured at amortised cost (net of any writedown for impairment):

- **Business model test:** The objective of the entity's business model is to hold the financial asset to collect the contractual cash flows (rather than to sell the instrument prior to its contractual maturity to realise its fair value changes).

- **Cash flow characteristics test:** The contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal outstanding.

There would likely need to be certain modest exemptions and *de minimis* allowances agreed for operational effectiveness and these are discussed in more detail below.

Subject to this and considering the assets and activities identified in Annex 7 of the ICB's Interim Report, no items which might have been 'permitted in retail banks' would be excluded.

Advantages

- An approach based on an accounting principle gives a clear and auditable basis on which to define the make-up of the RFB activities.

- This approach would permit the RFB to contain both retail and corporate deposits and the corresponding loans, thereby reducing the risks of major dislocation in UK funding for corporates and potentially also avoiding the grossing up of all UK banks' balance sheets which could arise if RFB was over funded but not able to pass its funding to its wholesale 'sister'.

- The risk structure profile of the assets included within the RFB would be essentially vanilla which would reduce the complexities of overall risk assessment for supervisors. In particular the RFB would avoid the complexity and subjectivity of 'Fair Value' measurement which can be affected by volatile market reference points, ineffective internal valuation models and optionality in the instruments that can lead to 'cliff effects' in valuations.

- The proposal would allow bank management to make decision around their individual business models for the RFB.

- This approach would avoid the need for an ‘artificial’ split of customers by size.

<u>Challenges to address</u>

- **Hedging of bona fide risks**

  IFRS 9 (in the ED) requires derivatives to be carried at fair value and some mechanism would need to be included to allow bona-fide hedging derivative activities in the RFB for example cash flow hedges to fund a fixed rate mortgage book. Note that IFRS 9 permits non-derivatives to be used as hedges, but only if they are carried at fair value which creates the same issue as the use of derivatives.

  The policing of derivatives or other hedging transactions could be effected through restrictions such as those in the current Building Society legislation which only permits the hedging of identifiable risks (required to be certified by an officer of the company).

  The Building Society Act prohibits entering into any transaction involving derivative investments unless it is entered into for the purpose of limiting the extent to which the society, or a connected undertaking of the society, will be affected by changes in any of the following factors:
    - interest rates;
    - exchange rates;
    - any index of retail prices;
    - any index of residential property prices; and
    - any index of the prices of securities.

  The IASB is currently also reviewing its hedging rules and again these may prove helpful.

- **Liquidity management**

  It is not entirely clear what level of turnover will be permitted under IFRS9 for a "held-to-collect" portfolio before being deemed not able to be designated as "held-to-collect". Whilst we currently see the majority of Balance Sheet Management (ie Treasury) activity as being accrual based under IFRS 9, not all "liquidity management" strategies would qualify.

  Depending on the interpretation of this point and the FSA requirements in respect of liquidity for the RFB, certain activities might need to be Fair Value accounted. For example, if the regulator required the RFB to demonstrate liquidity of the portfolio through regular turnover of the "liquidity portfolio".

The possible issue of Fair Value accounting for some instruments as a result of regular turnover of liquid assets within Balance Sheet Management could be addressed through agreeing adjustments to the FSA-prescribed permitted instruments list used for liquidity management which could negate the need for portfolio turnover.

- **FV Retail Products**

  Retail products such as insurance activities or structured products, for example guaranteed bonds, which do not meet amortised cost criteria would be excluded from the product offerings of the RFB.

  The issue of whether these product offerings could be offered by the RFB acting as agent would need to be considered.

  A further possibility would be to carve out a portion of the capital base that could be utilised for 'fair value' products and these could be further restricted as those offered to retail and small business customers.

- **AFS legacy portfolios and look through under IFRS9**

  Certain AFS portfolios contain legacy ABS assets could, under IFRS9, meet the amortised cost criteria. Without safeguards, a pure amortised cost model could lead to possibility of such positions being included with the RFB. However, it is likely that the business model test would deny inclusion as it is unlikely to be the case that the intention is to hold purely to collect cash flows. In any event, securitised assets would need to be the highest tranche(s) of a securitised structure to qualify and would need to have no optionality in their cashflows.

Conclusion

Overall, the probable outcome under this regime would be a separation closer to a Glass-Stegall type of basis. This would have certain inefficiencies but would be much preferable to a structure that risked separating funding from lending; in substance therefore the proposal outlined herein may meet the policy objectives set out by the ICB. The perimeter of the RFB could be significant in size but vanilla in risk type which seems to us to be an acceptable indeed perhaps desirable outcome given that it would avoid dislocation in funding; the activities contained within the RFB would of course be subject also to the more intrusive supervision regime now envisaged. We believe this structure is worthy of consideration and may be a necessary step to avoid the immense dislocation of funding markets for banks and UK corporates.

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