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VIA OVERNIGHT MAIL

March 26, 2007

Mr. John C. Dugan  
Comptroller of the Currency  
Office of the Comptroller of the Currency  
250 E. Street, SW  
Washington, DC 20219

Ms. Sheila C. Bair  
Chairman  
Federal Deposit Insurance Corporation  
550 17<sup>th</sup> Street, NW  
Washington, DC 20429

Mr. Ben S. Bernanke  
Chairman  
Board of Governors of the Federal  
Reserve System  
20<sup>th</sup> Street and Constitution Avenue, NW  
Washington, DC 20551

Mr. John C. Reich  
Director  
Office of Thrift Supervision  
1700 G Street, NW  
Washington, DC 20552

Re: Notice of Proposed Rulemaking - "Risk Based Capital Standards: Advanced Capital Adequacy Framework" 71 FR 55830 (September 25, 2006)

Dear Ms. Bair and Messrs. Dugan, Bernanke, and Reich:

HSBC North America Holdings Inc. ("HSBC North America") welcomes the opportunity to comment on the Risk Based Capital Standard: Advanced Capital Adequacy Framework Notice of Proposed Rulemaking (the "Basel II NPR" or the "NPR") issued jointly by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision (collectively, the "Agencies"). Our general comments, along with our recommendations for improving the new capital rule in the United States are contained in our previous letter dated December 12, 2006.

In this letter, we respond to the specific aspects of the NPR in three appendices covering:

- 1) Responses to certain questions posed by the Agencies in the Basel II NPR;
- 2) Responses to the four questions posed to "mandatory banks" included in the Basel IA NPR (Notice of Proposed Rulemaking - "Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance: Domestic Capital Modifications" 71 FR 77446 - December 26, 2006); and
- 3) Comments relating to the Advanced Capital Adequacy Framework Regulatory Reporting Requirements that were included in the Basel II NPR.

HSBC North America is a bank holding company that offers a wide range of financial services through bank and non-bank subsidiaries in the United States, Canada, and the United Kingdom. Our largest bank subsidiary, HSBC Bank U.S.A, N.A., Wilmington, Delaware, operates more than 400 branches, which are located in the states of New York, New Jersey, Florida, Pennsylvania, California, Washington, Oregon, and the District of Columbia. HSBC North America also owns HSBC Finance Corporation, which issues consumer credit cards through HSBC Bank Nevada, N.A., Las Vegas, Nevada, and consumer loans and mortgages through state licensed entities. Licensed subsidiaries of HSBC North America also provide insurance and securities products to commercial and retail customers. HSBC North America is a subsidiary of HSBC Holdings plc ("HSBC Group"), a banking organization based in the United Kingdom with operations in 80 countries.

With balance sheet assets of almost \$500 billion, HSBC North America will be a "mandatory" bank for purposes of Basel II in the United States (as currently prescribed) and thus required to implement the advanced internal ratings based ("A-IRB") approach for credit risk and the advanced measurement approach ("AMA") for operational risk with an "earliest possible" effective date of January 1, 2009. Additionally, as a wholly-owned subsidiary of HSBC Group, HSBC North America is also subject to the implementation schedule and capital rules as adopted for host jurisdictions by the UK Financial Services Authority ("FSA"), HSBC Group's home supervisor.

#### Executive Summary

HSBC North America supports the principles of Basel II. Specifically, we agree that large complex banking organizations should have robust risk management processes, that regulatory capital should be sensitive to business risk, and that a regulatory capital regime should be applied consistently among industry participants. In this regard, we support the Agencies' work to advance Basel II in the United States. Further, as an international organization, HSBC Group strongly supports the implementation of a global capital accord applied consistently in all major banking jurisdictions.

With that preface, as stated in our December 12, 2006, letter, we do not support the NPR in its current form. In many important areas, the proposed rule diverges sharply from both risk management principles and the International Accord<sup>1</sup> standards, imposing an extra layer of regulation on "mandatory" banks without providing corresponding benefits. In doing so, the NPR moves away from achieving one of the Basel Committee's principal objectives – that of creating a consistent global capital standard.

The NPR's divergence from the International Accord is of utmost importance to us as a banking organization which is owned by a large foreign parent. We believe the NPR variances are unnecessary and would carry significant negative consequences and

<sup>1</sup> "International Convergence of Capital Measurement and Capital Standards: A Revised Framework Comprehensive Version" ("International Accord"), June 2006

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burden for the organizations subject to them. In addition, many of these variances place arbitrary elements into the calculation of regulatory capital that will result in capital levels which do not accurately account for risk, and thereby reduce risk sensitivity, a principal objective of Basel II. This inefficient use of capital could place banking organizations in the United States who are subject to the rule at a significant competitive disadvantage when measured against other lending institutions, and could even discourage certain types of lending operations.

Regarding specific technical requirements in the NPR, we are particularly concerned with differing standards relating to:

- Large U.S. institutions being required to use the Basel II A-IRB and AMA approaches in the U.S. with no alternative options (question 7);
- The wholesale definition of default and the 5% loss threshold for sold or transferred exposures (question 14);
- The dual ELGD and LGD categories and the proposed use and estimation of LGD (question 16);
- Treatment of insurance underwriting subsidiaries (question 23); and
- The assigned AVC for certain retail portfolios (question 2).

At a minimum, we strongly advocate the portions of the NPR listed above that diverge significantly from international standards be eliminated. This approach would reduce unjustified regulatory costs and the significant compliance issues resulting from layered, differing home and host country regulatory rules. In adopting such an approach, the Agencies would thereby promote investment by large banking organizations in sound, advanced risk management processes.

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Again, HSBC North America appreciates this opportunity to submit these comments on the approach taken by the NPR, and I would be pleased to discuss these issues further.

Yours truly,

*David D. Gibbons  
by RMB.*

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SEVP and Chief Risk Officer  
HSBC North America Holdings Inc.

*Robert M. Butcher*

Robert M. Butcher  
SEVP and Chief Risk Officer  
HSBC U.S.A. Inc.

Cc: James W.G. Gunner (via email)  
Senior Executive  
HSBC Holdings plc

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Anthony J. DiLorenzo (via email)  
National Bank Examiner and Examiner-in-Charge  
Office of the Comptroller of the Currency

Anne Golden (via email)  
Examining Officer  
Federal Reserve Bank of New York

## Appendix 1

### Detailed Comments on Basel II NPR – Responses to Questions

As a member of the HSBC Group, our preference would be to implement Basel II according to the current international standards. However, we are responding to select questions posed in the NPR as if our U.S. operations may be subject to them, recognizing our responses may, in a few cases, differ from the international standards as they are specific to the elements of the NPR.

**1. The agencies seek comment on and the empirical analysis of the appropriateness of the proposed rule's AVCs for wholesale exposures in general and for various types of wholesale exposures (for example, commercial real estate exposures).**

**2. The agencies seek comment on and empirical evidence analysis of the appropriateness and risk sensitivity of the proposed rule's AVC for residential mortgage exposures, home equity lines of credit, and other mortgage products – and for other retail portfolios.**

Response: The AVCs are too high for several retail asset class portfolios and, in some cases, higher than internal estimates in wholesale product categories. Over time, the AVC will be influenced by lifecycle effects, risk management interaction, and the inherent underlying quality of the portfolio. Preliminary analysis by product shows that AVC can be higher or lower based on these three factors. Thus, banks should be permitted to use empirical analysis to account for these risk management actions. The AVC should not be a static number for all institutions. If an institution has internal estimates, they should be allowed to use them after an appropriate supervisory review.

**3. The agencies seek comment and supporting data on the appropriateness of this limit. (i.e., the proposed .6 percent limit on inclusion of excess reserves in tier 2 capital).**

Response: We believe that the entire Allowance for Loan and Lease Loss (ALLL) should be eligible for inclusion as capital available to absorb losses, without any limit on the amount that is included in Tier 2 capital. As the ALLL is the first buffer to all credit losses, the more an institution carries, the less capital is at risk.

We also note that changes to the Agencies' definition of eligible regulatory capital will impact a wide range of regulations that derive limits from it and thus recommend that the Agencies review and adjust those regulations accordingly (e.g., lending limits) to avoid undue burden to affected institutions and their customers.

**4. The agencies seek comment on the use of a segment approach rather than exposure-by-exposure approach for retail exposures.**

Response: In general, segmentation should follow an institution's internal practice for managing portfolios or loans. As such, in most cases, retail exposures are managed on

a portfolio basis, and we thus support the use of the segment approach based on asset class.

**5. The agencies seek comment on this approach (examining the change in capital through the transitional years and making adjustments as necessary to ensure capital does not go down by more than 10%) to ensuring overall capital objectives are achieved.**

**Response:** As a general comment, the NPR places undue weight on Pillar I calculations to ensure that U.S. banks maintain adequate capital resources. This top-heavy focus appears to have resulted in the inclusion of a variety of artificial limitations and prescriptive requirements in the NPR. These take a variety of forms, including extended transition periods and the 10% aggregate capital reduction limit. Such factors create disincentives for banks who may consider opting in to the advanced approaches, and further distance the NPR from both sound risk management practices and the Basel rules being implemented more uniformly by foreign central banks. We do not believe these artificial limitations are necessary so long as the Agencies balance each of the Basel Accord's three Pillars.

An approach more appropriate, we believe, than artificially high capital standards for all institutions, would be for the Agencies to address perceived weaknesses in Pillar I calculations on an institution-specific basis under the Supervisory Review provisions of Pillar II. To this end, we note that capital is frequently set to address external market expectations and internal capital measures that bear little if any relationship to the minimum standards established by regulation. Thus, historically, capital ratios have been maintained at levels well in excess of regulatory minimums, and we see no reason for this to change under Basel II and the extensive disclosure provisions of Pillar III.

**6. The agencies seek comment on all potential competitive aspects of this proposal and on any specific aspects of the proposal that might raise competitive concerns for any bank or group of banks.**

**Response:** As stated in our December 12, 2006 letter, the NPR contains requirements that differ significantly from the international framework adopted by the Basel Committee on Banking Supervision. The NPR's more significant variances include:

- Use of only the advanced approaches;
- Different definitions of "default";
- Extended transitional floor periods;
- Multiple Loss Given Default ("LGD") calculations;
- Different treatment for insurance subsidiaries and SMEs; and
- Introduction of a 10% aggregate industry capital reduction floor.

We believe these variances are unnecessary and would carry significant negative consequences for the organizations subject to them. Many of these variances place arbitrary elements into the calculation of regulatory capital that will result in higher capital levels for U.S. banks and capital which does not accurately account for risk.

This inefficient use of capital risks placing banking organizations in the United States who are subject to the rule at a significant competitive disadvantage relative to other financial institutions. Moreover, because the cost of carrying excess capital raises the cost of lending, the NPR in its current form could thereby render certain types of lending uneconomical for covered institutions.

**7. The agencies request comment on whether U.S. banks subject to the advanced approaches in the proposed rule (that is, core banks and opt-in banks) should be permitted to use other credit and operational risk approaches similar to those provide under the New Accord. With respect to the credit risk capital requirement, the agencies request comment on whether banks should be provided the option of using a U.S. version of the so-called "standardized approach" of the New Accord and on the appropriate length of time for such an option.**

Response: We strongly advocate the proposition that core banking organizations based in the United States have the option to adopt the Basel II Standardized Approach for calculating regulatory capital under Pillar I, and that the Agencies require the broad principles of A-IRB, AMA, and Economic Capital as matters of safety and soundness under Pillar II. This approach would advance risk management practices among large U.S. banking organizations and provide the Agencies with improved ability to align capital with risk through the existing supervisory process. The Agencies could publish principles-based supervisory guidance requiring large, complex banking organizations to develop and use advanced internal risk management techniques appropriate to the internal risk profile of the organization. This approach would provide the Agencies both with transparency into an organization's risk management practices and internal capital models, as well as the ability to require higher capital as deemed necessary.

At the same time, this approach would provide a more consistent capital framework among large U.S. banking organizations and their competitors based in foreign jurisdictions who do business in the United States, thereby creating a more level competitive playing field. Elimination of those portions of the NPR that diverge significantly from international standards would reduce unjustified regulatory costs along with the significant compliance issues resulting from layered, differing home and host country regulatory schemes. In adopting such an approach, the Agencies would promote investment by large banking organizations in sound advanced risk management processes, rather than in processes created solely to perform complex compliance exercises.

The Standardized Approach provides an alternative for institutions previously unwilling to 'opt-in' to A-IRB, providing the opportunity avail them of a more risk-sensitive, objectively derived RWA number. The Pillar II supervisory process will ensure that banks use an appropriate methodology specific to each institution's size, scope, and structure.

*For additional comments on this issue, please refer to Appendix 2.*

**8b. The agencies seek comment on the proposed scope of application. In particular, the agencies seek comment on the regulatory burden of a framework that requires the advanced approaches to be implemented by each subsidiary DI of a BHC or bank that uses the advanced approaches.**

Response: HSBC North America owns several small bank subsidiaries that are limited in the scope of their activities. For the most part, these entities hold substantial capital positions against minimal credit risk and asset exposures. While it is our intention, for consolidation purposes, to treat risk in each subsidiary under the advanced approaches, we see no value in requiring each to meet stand-alone minimum capital and reporting requirements using the Basel II framework. To do so would create excessive regulatory burden and cost. In lieu of this, on a stand-alone basis, we request that these entities be allowed to continue to follow capital reporting rules as required based on their legal structure, asset size, or supervisory agency ( e.g., small U.S. banking entities would currently follow Basel I).

**10. The agencies seek commentary on this approach (using Basel IA as the floor basis if it is effective before the final rule is effective) and on how and to what extent future modifications to the general risk-based capital rules should be incorporated into transitional floor calculations for advanced approaches banks.**

Response: Mandatory Basel II institutions should be permitted to calculate the capital floor according to Basel I during the transitional floor years. Requiring these organizations to develop yet a third system, and one which is intended to become obsolete, would neither be cost effective nor provide any supervisory value. Along these lines, we acknowledge the recent position stated by the Agencies in the Basel IA NPR indicating that Basel IA would not be available to large, complex international banking organizations subject to the proposed Basel II advanced capital framework and as such, would not be used as the floor basis.

**12. The agencies seek comment on this proposed timetable for implementing the advanced approaches in the U.S.**

Response: Covered institutions will require flexible timeframes to implement the final rules, due to operational changes that may be required as a result of the Agencies' final published Supervisory Guidance and regulations. This is a particularly sensitive issue for institutions facing diverging rules because existing global systems and processes would require significant adjustment and cost to bring them into compliance with individual U.S. standards. That said, we encourage timely U.S. implementation to reduce the duration of any competitive advantage for banks not subject to the advanced approaches in the U.S. rules.

Flexibility should be built in to the implementation framework by allowing institutions to begin parallel reporting even with known self-identified gaps that are in the process of remediation. Little downside risk would result from this approach, as institutions will be reporting two sets of capital numbers. The parallel year could be used as an opportunity for open dialog between institutions and the Agencies to clarify application of the rules and to allow organizations to bring their risk models into compliance with the



final rules and supervisory expectations. Such a period of collaborative implementation would help to address some of the hurdles faced by organizations such as HSBC North America whose foreign parents operate under different versions of Basel II.

**13. The agencies seek comment on this aspect of the proposed rule and on any circumstances under which it would be appropriate to assign different obligor ratings to different exposures to the same obligor (for example, income producing property lending or exposures involving transfer risk).**

Response: Lenders should have the flexibility to assign separate ratings to different exposures of the same obligor where appropriate. In cases of IPRE, there are many circumstances under which PDs at the individual facility level may be assigned. With multiple exposures to a single obligor, default probability is more closely related to the cash flows of the individual property than to the overall condition of the obligor. Therefore, assigning PD ratings at the facility level is appropriate, except in the case of a special purpose entity owning only a single IPRE. In the case of multiple exposures, loan documents may also contain provisions that prevent cross-default treatment of exposures if the obligor defaults on one facility.

Selection of remedies for recovery must also be considered. Banks lending in states with 'single-action' laws prevent the lender from recovering repayment both from the obligor through bankruptcy proceedings and from the collateral through foreclosure. As the lender must determine the most advantageous position on a case-by-case basis, collateral value is relevant to both default probability and recovery collection.

**14. The agencies seek comment on this proposed definition of default and how it captures substantially all of the circumstances under which a bank could experience a material credit-related economic loss on a wholesale exposure. In particular, the agencies seek comment on the appropriateness of the 5% loss threshold for exposures sold or transferred between reporting categories. The agencies also seek commenters' views on specific issues raised by applying different definitions of default in multiple national jurisdictions and on ways to minimize potential regulatory burden, including the use of the definition of default in the New Accord, keeping in mind that national bank supervisory authorities must adopt default definitions that are appropriate in light of national banking practices and conditions.**

Response: The proposed definition of default captures substantially all of the attendant circumstances. However, the five percent threshold appears arbitrary and does not reflect external data. Percentage changes in the market value of loans and related instruments cannot always be ascribed to market, credit, and liquidity shifts. Indeed, a five percent decline in the price of a loan may reflect industry issues that are separate from credit quality and/or the existence and quality of collateral (and collateral is not related to PD). This treatment may have the unintended consequence of discouraging institutions from buying or selling assets to manage the risk of its wholesale loan portfolio.

The identification of credit-related loss at sale may prove difficult at best and will impede appropriate estimations of PDs and LGDs, including, but not limited to, the identification of assets and contamination of pooled data as derived from alternate sources.

We would also suggest that the Agencies consider the global definition of default in finalizing the NPR. Variances between the NPR and non-U.S. definitions create unnecessary complexity of analysis and compliance for multinational institutions. Thus, we would recommend that such multinational organizations be offered the flexibility to follow common standards across entities when developing global models to reduce compliance costs across the various jurisdictions. Moreover, if the definitions are not aligned, we would recommend that institutions be given the flexibility to choose between the Basel International Accord and U.S. versions of the default definition for wholesale credits. Such an option will likely have little impact on regulatory capital calculations, but will significantly reduce compliance burden. Pillar II supervisory oversight will provide the opportunity to evaluate each institution on a case-by-case basis.

**15. In light of the possibility of significant increased loss rates at the subdivision level due to downturn conditions in the subdivision, the agencies seek comment on whether to require banks to determine economic downturn conditions at a more granular level than an entire wholesale or retail exposure subcategory in a national jurisdiction.**

Response: Because large international banks generally operate at a macro national level, it is not necessary to determine economic downturn conditions at a level more granular than an entire wholesale or retail exposure subcategory. These portfolios are generally geographically balanced and based on national interest rates and GDP. Moreover, the availability of data at the subcategory level is likely to be sparse or nonexistent. In fact, focusing on a more granular business line or subdivision will eliminate certain data, potentially reducing the predictive power of the model. Thus, a balance must be struck between granularity and the reality of declining predictive power as one shrinks the sample size. The benefit of more granular subdivision would be small relative to the cost.

Adding geographic granularity for establishing LGD on a highly granulated sub-product basis may also have other economic consequences. In particular, such requirements may have the adverse effect of discouraging product diversification with portfolios. Moreover, increasing capital requirements for similar credit products has the further effect of adding to competitive inequity between U.S. and non-U.S. banks.

Should such a degree of granularity be required over time, we would recommend that the Standardized Approach be available for use when the underlying default data proves insufficient for meaningful analysis.

**16. The agencies seek comment and supporting empirical analysis of (i) the proposed rule's definition of LGD and ELGD; (ii) the proposed rule's overall approach to LGD estimation; (iii) the appropriateness of requiring a bank to produce credible and reliable internal estimates of LGD for all its wholesale and retail exposures as a precondition for using the advanced approaches; (iv) the appropriateness of requiring all banks to use supervisory mapping function, rather than internal estimates for estimating LGDs due to limited data available and lack of industry expertise with incorporating economic downturn conditions in LGD estimates; (v) the appropriateness of proposed supervisory mapping function for translating ELGD into LGD for all portfolios of exposures and possible alternative supervisory mapping functions; (vi) exposures for which no**

mapping function would be appropriate; and (vii) exposures for which more lenient or more strict mapping function may be appropriate.

Response:

The addition of a new LGD metric (ELGD and LGD) is a departure from the Basel framework. We believe the addition adds a great deal of complication and cost to the capital calculation process without corresponding added risk management or capital sensitivity benefit. In addition, it would make comparisons across national jurisdictions difficult if not meaningless.

We understand the challenges posed by producing reliable LGD estimates where internal data in several portfolios is lacking. To address this, we would thus suggest that a Pillar II approach may address LGD estimation more effectively. Thus, rather than mandating a particular formula, it may be more appropriate for the local regulators to opine on the overall robustness of the LGD estimation and calculation, particularly within the context of the overall risk rating system.

In addition, we would not recommend requiring all banks to use the mapping function rather than internal estimates. The Agencies should permit organizations to use the mapping function on certain portfolios with limited data availability, and to concurrently use internal estimates for LGD on portfolios with robust data that can create reliable and credible estimates. Mandating use of the supervisory mapping function would essentially exclude from A-IRB treatment any institution that has managed to avoid a statistically-valid sample size of defaults during a downturn period. The Agencies would retain the ability to oversee the appropriate use of the mapping function vs. internal estimates to ensure rational results.

**17. The agencies seek comment on the extent to which ELGD or LGD estimates under the proposed rule would be pro-cyclical, particularly for longer-term secured exposures. The agencies also seek comment on alternative approaches to measuring ELGDs or LGDs that would address concerns regarding potential pro-cyclicality without imposing undue burden on banks.**

Response: To the extent that the NPR results in higher capital requirements in the U.S. than in other countries, the NPR will likely have a pro-cyclical effect on capital requirements in the U.S. The pro-cyclical effect would occur as a result of changes in loan pricing caused by regulatory capital requirements, as well as from the effects of internal economic capital models.

To address this concern, we would recommend that the Agencies adopt an approach that is less prescriptive than the NPR, and rather relies to a greater degree on the supervisory oversight of Pillar 2 to determine LGDs for individual institutions. Such an approach should be implemented in conjunction with existing safeguards to reduce undue regulatory burden.

**18. The agencies seek comment on the feasibility of recognizing such pre-default changes in exposure in a way that is consistent with the safety and soundness objectives of this proposed**

rule. The agencies also seek comment on appropriate restrictions to place on any such recognition to ensure that the results are not counter to the objectives of this proposal to ensure adequate capital within a more risk sensitive capital framework. In addition, the agencies seek comment on whether, for wholesale exposures, allowing ELGD and LGD to reflect anticipated future contractual paydowns prior to default may be inconsistent with the proposed rule's imposition of a one year floor on M or may lead to some double-counting of the risk mitigating benefits of shorter maturities for exposures not subject to this floor.

Response: For wholesale exposures, the use of paydowns to reduce ELGDs and LGDs appears to be overly prescriptive. This aspect of the calculation of ELGD and LGD may be better achieved by using Pillar 2 supervisory guidance to best determine the relationship of ELGDs and LGDs to the ratio of losses to actual balance at default at a particular institution.

19. The agencies solicit comment on all aspects of the proposed treatment of operational loss and, in particular, on (i) the appropriateness of the proposed definition of operational loss; (ii) whether the agencies should define operational loss in terms of the effect an operational loss event has on the bank's regulatory capital or should consider a broader definition based on economic capital concepts; and (iii) how the agencies should address the potential double-counting issue for premises and other fixed assets.

Response:

(i) We agree with the proposed definition of operational loss.

(ii) We agree that the definition of operational loss should relate to its impact on regulatory capital rather than being based on a broader definition of economic capital concepts.

(iii) Double counting and commingling are challenging issues for operational risk. Sometimes, operational losses occur due to events that also produce other types of losses (e.g., credit). Banks often will record the total loss of the event within their systems without partitioning according to risk type. Whether this issue is addressed in the definition of operational loss or in the supporting commentary, banks should be encouraged to separate losses to operational events from losses due to other risks. It is important that losses are captured, not the granularity with which they are captured.

20. The agencies seek comment on the appropriateness of the 24 month and 30 day time frames for addressing the merger and acquisition transition situations advanced approaches banks may face.

Response: We believe that the 30-day period is too short for development of an implementation plan and would recommend a 90-day period as more appropriate. A 24-month period is a reasonable time period for implementation if an institution is merging or acquiring another Basel II A-IRB institution. However, if the merger or acquisition is with an institution not subject to Basel II A-IRB bank, 36 months is more appropriate.

**21. Commenters are encouraged to provide views on the proposed adjustments to the components of the risk based capital numerator as described below. Commenters also may provide views on numerator related issues that they believe would be useful to the agencies consideration of the proposed rule.**

**Response:** Rather than adjusting the numerator for capital deductions for such items as the shortfall of eligible loan reserves below total expected losses or for securitized exposures rated below investment grade, we propose that the Agencies allow the denominator to be adjusted by applying a risk weight of 1250% to the nominal value of the proposed deductions. This would prevent reductions in other items linked to the level of regulatory capital such as the materiality test for equity exposures.

**22. The agencies seek comment on the proposed ECL approach for defaulted exposures as well as on an alternative treatment, under which ECL for a defaulted exposure would be calculated as the banks current carrying value of the exposure multiplied by the banks best estimate of expected economic loss rate associated with the exposure (measured relative to the current carrying value), that would be more consistent with the proposed treatment of ECL for non defaulted exposures. The agencies also seek comment on whether these two approaches would likely produce materially different ECL estimates for defaulted exposures. In addition, the agencies seek comment on the appropriate measure of ECL for assets held at fair value with gains and losses flowing through earnings.**

**Response:** We support the proposed ECL approach as currently stated in the NPR. We agree that any difference between a bank's best estimate of economic losses and its impairment estimate for ALLL purposes is likely to be small and therefore the alternative treatment would entail additional burden, with little additional benefit for capital estimation.

**23. The Board seeks comment on the capital approach proposed for insurance underwriting subs and in particular on how a minimum insurance regulatory capital proxy for tier 1 deduction purposes should be determined for insurance underwriting subsidiaries that are not subject to U.S. functional regulation.**

**Response:** We strongly recommend that the NPR follow the Basel Committee's recommendation for the treatment of insurance underwriting subsidiaries. According to that approach, the assets of insurance underwriting subsidiaries would be deconsolidated from the assets of the bank holding company and their capital deducted from the consolidated equity of the bank holding company. In contrast, the approach proposed by the NPR to consolidate and risk-weight the assets of the insurance subsidiaries while also deducting them from the parent institution's capital would effectively impose a double or even triple capital requirement on those assets.

In particular, the NPR's proposed requirement of a tier one capital deduction of 200 percent of the insurance subsidiary's Authorized Control Level as established by the appropriate state insurance regulator is excessive. This requirement suggests that the Agencies consider the risk-based capital standards established by state insurance regulators to be inadequate. We would submit that the risk-based capital rules applicable to insurance companies represent a comprehensive approach to capital

adequacy by considering the adequacy of reserving for catastrophic events, line of business insured, limits of coverage, credit risk of counterparties (default by agent or reinsurer), investment and off-balance sheet risks, among other factors.

In addition to the double counting and required deduction from tier 1 capital, the NPR would require the assets of the insurance subsidiary to be consolidated for purposes of determining a bank holding company's risk-weighted assets. Effectively, this requirement would constitute double or triple counting (when combined with the 200% deduct from tier 1 capital) for the holding company. The competitive disadvantage to insurance companies owned by U.S. bank holding companies would be potentially significant in comparison to insurance companies owned by non-U.S. companies or non-bank holding companies.

**24. The agencies seek comment on how to strike the appropriate balance between the enhanced risk sensitivity and marginally higher risk based capital requirements obtained by separating HVCRE exposures from other wholesale exposures and the additional complexity the separation entails.**

Response: This approach is consistent with that in the International Accord and we recognize that certain identification parameters, i.e., capital contributions, completed values, may be difficult to ascertain on a systematic basis.

**25. The agencies seek comment and supporting evidence on the consistency of the proposed treatment with the underlying riskiness of SME portfolios. Further, the agencies request comment on any competitive issues in this aspect of the proposed rule may cause for U.S. banks.**

Response: We see no reason to diverge from the approach adopted by the Basel Committee that applies a lower capital treatment for SME exposures treated as commercial. Not only is this approach consistent with the International Accord, but it also parallels the proposed suggestion in the Basel IA NPR to consider a lower risk weight for certain SME exposures up to \$1 million.

**27. The agencies seek commenters' perspective on other loss types for which the boundary between credit and operational risk should be evaluated further (for example, with respect to losses on HELOCs)**

Response: The NPR's distinction between credit risk and operational risk appears reasonable.

**28. The agencies generally seek comment on the proposed treatment of the boundaries between credit, operational, and market risk.**

Response: We participated in the comment letter to the Market Risk NPR that was submitted to the Agencies on January 23, 2007, under the signatures of the Institute of International Finance, the International Swaps and Derivatives Association, the RMA and the London Investment Banking Association. While we did not issue a separate letter, we endorse the positions stated in the January 23, 2007, letter.

As noted by these associations, we are particularly concerned with the prescriptive rules that bifurcate the trading book into positions that are covered by the proposed market risk rules and positions that would have their risk-weighted assets calculated by banking rules (e.g., rules for equity investments or securitization). Such bifurcation could create a material breakage between the accounting and regulatory classification and treatment of positions. Thus we would recommend that all positions in the trading book be treated under the Market Risk rules and be captured by and included in the measurement of VAR. Additionally, we believe that the definition of operational risk should include a statement that operational risks exclude losses due to the default of a counterparty or adverse valuations.

**30. The agencies seek comment on wholesale and retail exposure types for which banks are not able to calculate PD, ELGD, LGD and on what an appropriate risk based capital treatment for such exposures might be.**

Response: We support the use of an alternative risk based capital treatment for exposures where institutions are unable to calculate reliable PD, ELGD, and LGD estimates. Such treatment should follow a Basel II Standardized approach (if adopted in the U.S.) or, if not adopted, a Basel I risk-weight allocation.

**31. The agencies seek comment on the appropriateness of permitting a bank to consider prepayments when estimating M and on the feasibility and advisability of using discounted (rather than undiscounted) cash flows as the basis of M.**

Response: We would recommend that the Agencies emphasize Pillar II oversight for estimating M. While in some cases the use of expected prepayments may be more appropriate when calculating M, institutions should be allowed the alternative of using discounted cash flows, which would allow them to weigh the costs and benefits of increased calculation burden against a more conservative capital treatment.

**32. The agencies seek comment on whether the agencies should impose the following criteria as additional requirements for a Basel II bank to qualify for the statutory 50% risk weight for a particular mortgage loan: (i) that the bank has an IRB risk measurement and management system in place that assesses the PD and LGD of prospective residential mortgage exposures; and (ii) that the bank's IRB system generates a 50% risk weight for the loan under IRB risk based capital formulas.**

Response: We do not support these additional requirements for loans which qualify for the statutory 50% risk weight under the Resolution Trust Corporation Refinancing, Restructuring, and Improvement Act of 1991 ("RTCRI"). The proposal would require Basel II banks to separate out the mortgage loans that meet the RTCRI criteria and estimate the capital requirement differently (i.e., going through another step to ensure the statutory 50% risk weight for a RTCRI loans). This requirement represents yet another variation by the U.S. rules from the international treatment, and thus we recommend that the Agencies allow for A-IRB risk weights to be assigned, regardless if they are higher or lower than the risk weights provided for in the RTCRI Act. As alluded to in the preamble to the NPR, such an approach would be consistent with the

congressional purpose of a capital-related provision of the Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA"), enacted by Congress just four days after its adoption of the RTCRRI Act, which directs the Agencies to revise their risk-based capital standards to ensure that those standards "reflect the actual performance and expected risk of loss of multifamily mortgages."<sup>2</sup>

**Questions 34 - 41. Questions 34-41 deal with counter-party credit risk.**

Response: We manage our Investment Banking and Markets business on a global basis. As a member of the Institute of International Finance ("IIF"), we are part of a capital working group that is separately responding to the NPR. The IIF comment letter will respond to questions 34 to 41 concerning counter-party credit risk, and we endorse the positions stated in that response.

**42. The agencies seek comment on this alternative's approach definition of eligible retail guarantee and treatment for eligible retail guarantees, and on whether the agencies should provide similar treatment for any other forms of wholesale credit insurance or guarantees on retail exposures, such as student loans, if the agencies adopt this approach.**

**43. The agencies seek comment on the types of non-eligible retail guarantees banks obtain and the extent to which banks obtain credit risk mitigation in the form of non-eligible retail guarantees.**

**44. The agencies seek comment on both of these alternative approaches to guarantees that cover retail exposures. The agencies also invite comment on other possible prudential treatments for such guarantees.**

Response 42 - 44: Questions 42 – 44 deal with the proposed treatment for retail guarantees. We support the proposed approach of adjusting LGD estimates to assess the effect of eligible retail guarantees (in the form of PMI from a highly rated insurer), and make no adjustments to PD. This approach is consistent with internal practice and would reduce compliance burden. We do not support the alternative treatment.

**45. – 54. Questions 45-54 deal with securitizations.**

Response: HNAH's legal entities are involved in securitizations as an investor, issuer, and sponsor of ABCP conduits. As a member of the Risk Management Association ("RMA") we are part of a capital working group that is separately responding to the NPR. The RMA comment letter addresses the treatment of securitizations and we endorse the positions stated in that response.

**55. – 59. Questions 55-59 deal with equity exposures.**

Response: HSBC North America is currently under the 10% materially threshold for A-IRB treatment of equity exposures, and we support the current defined threshold and treatment for immaterial exposures. That said, as a member of the Institute of International Finance ("IIF"), we are part of a capital working group that is separately

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<sup>2</sup> Section 305(b)(1)(B) of FDICIA (12 U.S.C. 1828 notes).



responding to the NPR. The IIF comment letter addresses the treatment of equity exposures and should our equity holdings increase, we endorse the positions stated in that response.

**60. The agencies are interested on commenters' views on other business lines or event types in which highly predictable, routine losses have been observed.**

Response: We have no other examples of predictable, routine operational loss events and thus support the NPR as currently proposed.

**62. Comments on regulatory reporting issues May be submitted in response to this NPR as well as through the regulatory reporting request for comment noted above.**

Response: See appendix 3.

## Appendix 2

### Detailed Comments on Basel IA NPR – Responses to Four Questions for Mandatory Basel II Banks

Please refer to our letter of January 18, 2006, (attached as Appendix 4) for specific comments and recommendations regarding the Basel IA ANPR which, conceptually, apply equally to this new NPR. We do, however, appreciate the opportunity to reply separately to questions 19 to 23.

**19. To what extent should the Agencies consider allowing Basel II banking organizations the option to calculate their risk based capital requirements using approaches other than the Advanced Internal Ratings Based (AIRB) for credit risk and the Advanced Measurement Approach (AMA) for operational risk? What would be the appropriate length of time for such an option?**

Response: In our Basel II NPR comment letter dated December 12, 2006, we recommended that the U.S. final rules be harmonized with those of the Basel Committee. Consistent with that theme, for credit risk, we would suggest that the Agencies permit all U.S. banks to select one of the three approaches permitted in the Basel Accord - the Standardized, IRB Foundation, or IRB Advanced, and allow partial adoption of IRB approaches where this is permitted in the Accord. Similarly, with respect to measuring operational risk, we would suggest that the Agencies permit all U.S. banks to use the three approaches of the Basel Accord: specifically, the Basic Indicator, Standardized, or AMA. Provided that these options are made available, we recommend that the agencies require all U.S. banks, not simply "mandatory" banks, to adopt Basel II for safety and soundness purposes.

**20. If Basel II banking organizations are provided the option to use alternatives to the advanced approaches, would either this Basel IA proposal or the standard approach in Basel II be a suitable basis for a regulatory capital framework for credit risk for those organizations? What modifications would make either of these proposals more appropriate for use by large complex banking organizations? For example, what approaches should be considered for derivatives and other capital markets transactions, unsettled trades, equity exposures, and other significant risks and exposures typical of Basel II banking organizations?**

Response: We strongly recommend that the Basel II Standardized approach for credit risk be established as a suitable regulatory capital framework for U.S. institutions. We suggest that the Standardized approach, when coupled with the new Market Risk Amendment adequately addresses other exposures for large complex banking organizations such as the treatment of derivatives under the credit mitigation provisions and for equities and securitizations.

**21. The risk weights in this Basel IA proposal were designed with the assumption that there would be no accompanying capital charge for operational risk. Basel II, however, requires banking**

**organizations to calculate capital requirements for exposures to both credit risk and operational risk. If the Agencies were to proceed with a rulemaking for a U.S. version of a standard approach for credit risk, should operational risk be addressed using one of the three methods set forth in Basel II?**

**Response:** Yes, we would suggest that all U.S. banking organizations be required to include a capital charge for operational risk and be allowed to select any of the three Basel Accord approaches.

**22. What additional requirements should the Agencies consider to encourage Basel II banking organizations to enhance their risk management practices or their disclosures, if they are provided the option to use the alternatives to the advanced approaches of the Basel II NPR?**

**Response:** We strongly recommend that Basel II banking organizations be allowed to adopt the Standardized approach while they transition to the advanced risk management approaches. Harmonizing the U.S. final rule with the Basel II Accord, combined with a more flexible, pragmatic implementation approach administered under the supervisory standards of Pillar II, would encourage institutions to bring their risk management practices more in line with internal capital management standards and measurements of risk. To the extent the Agencies have specific safety and soundness concerns related to specific risk management or other capital practices, these can be addressed in guidance or regulations specific to those operations, and, if necessary, through directives related to specific institutions.

### Appendix 3

#### Basel II NPR - Response to Advanced Capital Adequacy Framework – Regulatory Reporting Requirements

The Advanced Capital Adequacy Framework Regulatory Reporting Requirements are included in the Basel II NPR dated September 25, 2006. The Agencies have expressed concern for the potential burden of complying with the reporting templates.

One of the central themes of our December 12, 2006, NPR comment letter was the recommendation that the U.S. rule be harmonized with that of the Basel Committee's Accord, in order to reduce the differences between home and host interpretations. Consistent with that theme, we believe strongly that standard reporting requirements should be adopted by all jurisdictions subject to the Basel II Accord. The alternative of inconsistent regulatory reporting requirements will increase significantly the regulatory burden on large international banking organizations such as HSBC North America. We are also concerned that differences between international reporting standards and local rules could potentially give rise to regulatory interpretations that are not shared globally. This could result in unilateral modifications to the rule that are not universally adopted and create differences in the local rule from that of the Accord.

Another central theme of our December letter related to the prescriptive aspects of the NPR that distanced the rule from established principles of sound capital management. As part of our capital management framework, analytical standards and internal reports have been developed to strengthen controls and portfolio management practices. As a general comment, a final rule and accompanying reporting standard that are highly prescriptive and differ widely from established risk management practices would require separate production processes and analytical frameworks to satisfy both regulatory and internal requirements at a potentially high cost. This significant burden, we believe, would lack corresponding supervisory justification.

The specific comments that follow are referenced to the four requests for comment listed in the NPR template package.

1. **The feasibility of collecting certain additional information to help identify the causes of changes in credit risk regulatory capital, e.g. rating grade migration trends, changes in exposure mix.**

Response: Our credit data warehouse is structured to enable us to analyze multiple periods of historical risk information. Wholesale exposure data can be reviewed individually or aggregated by the credit risk rating scale or industry classification.

2. **Alternative reporting treatment for wholesale and retail portions (Schedules C-R).**

**Response:** To reduce burden and better align regulatory reporting with internal practices, we favor an alternative, as suggested in the NPR, which would allow banks to report according its credit risk rating scale rather than fitting calculations to the prescribed supervisory bands listed on schedules C -R.

**3. Public Disclosure of the data items on Schedules A and B and items 1 through 7 of Schedule V, for operational risk reporting.**

**Response:** We would recommend maintaining the confidentiality of information provided by banking organizations on the reporting templates until the end of all the transitional periods. The industry is still analyzing a range of practices to best develop their risk frameworks for quantifying credit and operational risk. To date, no clear standard for best practice has emerged. We are concerned that any attempt by third parties to make judgments or bank-to-bank comparisons based solely on the proposed schedules, particularly without accompanying text, would be highly subjective.

**4. Proposed changes in the regulatory reporting requirements and alternative ways to capture the requested information.**

**Response:** As discussed above, we strongly recommend that a common international standard be adopted for Basel II reporting purposes.

**Additional Comment**

**Schedule A - The Calculation of Total Risk-Based Capital**

Total risk-based capital, as defined by the NPR, is used as the standard to determine the threshold limit for "non-significant" equity exposures. This limit, and others based on the NPR's definition of risk-based capital, would be decreased by the treatment proposed in the NPR ( and Schedule A) to reduce regulatory capital by the shortfall of eligible loan reserves below total expected losses and by securitized exposures rated below investment grade. We would propose an alternative to this proposed direct capital deduction, that the Agencies apply a risk weight of 1250% to the nominal value of the two items noted above . This would preserve the value of eligible capital upon which the equity threshold limit is based without impacting the value of the capital ratio calculation.