HSBC

April 30, 2013

Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Attention: Robert deV. Frierson, Secretary

Re: Enhanced Prudential Standards and Early Remediation Requirements for Foreign Banking Organizations and Foreign Nonbank Financial Companies; Proposed Rule; 77 Federal Register 76,628; December 28, 2012; FRB Docket No. 1438 and RIN 7100 AD 86

Ladies and Gentlemen:

HSBC North America Holdings Inc. ("HNAH") and its global affiliates (collectively, "HSBC") appreciate the opportunity to submit comments regarding the proposed rules (the "Proposed Rules")[1] on Enhanced Prudential Standards and Early Remediation Requirements for Foreign Banking Organizations and Foreign Nonbank Financial Companies issued by the Board of Governors of the Federal Reserve System (the "Board"). The Proposed Rules would implement the enhanced prudential standards required to be established under section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") and the early remediation requirements required to be established under section166 of the Dodd-Frank Act for foreign banking organizations and foreign nonbank financial companies supervised by the Board.

HSBC's structure in the U.S. (as detailed below) is in line with the broad thrust of the Proposed Rules and, therefore, we anticipate that the Proposed Rules will have a very limited impact on HSBC. Nonetheless, we offer general comments on the broad implications for both the U.S. and global financial systems of the Proposed Rules as well as some observations on how more detailed aspects of the Proposed Rules could affect HSBC's U.S. operations. On the latter, we have two specific requests detailed later in this letter:

(i) that there be a consistent approach across the Proposed Rules to parent Foreign Banking Organizations ("FBOs") where an FBO has no branch operations in the U.S. (as is the case for HSBC); and

(ii) that the Board provide flexibility in the operational requirements where an FBO already employs a single holding company for its U.S. operations similar to U.S. banking institutions.

[1] Enhanced Prudential Standards and Early Remediation Requirements for Foreign Banking Organizations and Foreign Nonbank Financial Companies, 77 Fed. Reg. 76,628 (proposed Dec. 14, 2012) (to be codified at 12 CFR Part 252).

A. Structure of the HSBC Group and HNAH

In the context of the proposed rules, it is important to understand the structure and operations of the HSBC Group and particularly its activities in the U.S.

As an international financial services company, HSBC provides financial services to a broad spectrum of clients in over eighty countries. HSBC is structured as a global holding company with separate legal operating subsidiaries throughout the world, each of which is subject to local regulation. The global HSBC network includes, among other entities, HSBC Bank plc in the United Kingdom, HSBC France in France, The Hongkong and Shanghai Banking Corporation Limited in Hong Kong, HSBC Bank Canada in Canada, and HSBC Bank USA, National Association ("HBUS") with over $185 billion in assets in the United States. HSBC also has a significant local presence in many other jurisdictions that supports the growth and development of various emerging markets such as through HSBC Mexico S.A. and HSBC Bank Brasil S.A. in Latin America and HSBC Bank Middle East Limited in the Middle East.
HSBC operates in the U.S. primarily through U.S.-domiciled legal entities, including banks, non-bank finance companies, and a broker-dealer, all held under a U.S. holding company. For reference, a simple diagram of our operations is attached as Appendix 1.

B. Implications for International Banking and Resolution

1. Potential Change of International Resolution Model

Taken as a whole, the Proposed Rules may be seen as setting the stage for the geographic ring-fencing of FBOs in the U.S. They fall short of full subsidiarization since branch banking is still permitted but there is at least a suggestion that the Board may consider this step in the future. In the short term, for banks which have not been operating on a local basis, the Proposed Rules would establish much closer Board oversight of local liquidity and asset coverage ratios as well as the global capital ratios of the parent FBO.

We believe that most observers will conclude that the Proposed Rules are driven by a lack of confidence by the Board in the ability of regulators around the world to reach the necessary Cooperation Agreements which would support a global Single Point of Entry approach for international banks. In simple terms, the Proposed Rules could be seen as trying to achieve what might be described as a Single Point of Entry approach for an FBO's U.S. activities but with an assumption that a Multiple Point of Entry approach may be necessary at an international level.

For many banks, it will be a concern that this stance from the respected U.S. authorities will be taken as a 'direction of travel' by other regulators. Accordingly, there is a risk that the U.S. measures on geographic ring-fencing will encourage other countries to enact similar measures or strengthen existing policies to ensure that they have the same protections as those being sought by the U.S. supervisors. This trend could have material consequences for U.S. banks in foreign jurisdictions, particularly if this approach is taken to an ultimate conclusion and local incorporation of all operations, with limited financial managerial and operational links to parent companies and affiliates is mandatory, either by rule or by economic constraints. Overall, this could precipitate a major change in the structure of international banking with significant consequences, as we discuss below.

As a firm, HSBC is comfortable with a Multiple Point of Entry approach to resolution. It reflects our organisational structure and, given this, it is the strategy which we have proposed to our regulators as being most appropriate for the Group. The disclosure to this effect in our recent 20-F filing is attached as Appendix 2. As a result, we do not anticipate material financial effects, although we have highlighted some administrative issues which are relevant to our particular circumstances which are set out in Section C of this letter.

2. <u>Effects of Change of International Resolution Model</u>

However, we also believe there are good reasons why the U.S. and other jurisdictions should take steps to maintain the diversity of banking models. There are systemic risks if all providers of finance are organised in a similar fashion and rely in the same pools of capital, liquidity and funding.

Furthermore, we have concerns about the transition of other banks to a local capital and funding regime, whether in the U.S. or on a wider basis, and its economic consequences.

- <u>Capital</u>: Given the effects of national ring-fencing of capital, this will almost inevitably lead to some increase in the total capital requirements for these firms. This can be mitigated if there is a clear understanding that surplus capital in local entities (i.e., above Basel III and any D-SIB requirements) could and would be released as dividends to ultimate holding companies to be deployed to other entities within the group. Some of the proposals on early remediation would work against that; we discuss this later in this letter.

- <u>Funding</u>: Subsidiarization would also lead to a greater reliance on local funding by these banks. Given that the supply of local retail or wholesale funds is limited, and cross-border funding would be curtailed, this risks reducing the overall capacity for lending. Consideration will also need to be given to the implications for liquidity planning; for example, given the inability of banks to source funding from their parent firms, there will be much more immediate pressure on the Lender-of-Last-Resort at times of stress.

If a plethora of other banks are required to make these substantial adjustments, alongside the already significant challenges of implementing the higher capital, funding and liquidity requirements of the Basel III framework, this is likely to have a detrimental effect on the ability of banks to provide credit to their local economies. Although HSBC is not directly affected, as a major player in the global financial system, we are concerned about these wider consequences.

3. <u>Options to Avoid Change of International Resolution Model</u>
We see two options for the Board to consider if it wishes to avoid the potential changes to the international resolution model.

Firstly, it might be helpful for the Board to set out any steps which banks (and, potentially, their national regulators) could take to deliver the international cooperation which would enable agreements between regulators to be reached and make this ring-fencing unnecessary. These may have been discussed in private but a clearer exposition may enable parties to balance more effectively the requirements which are being sought and the consequences if these cannot be satisfied. It would also establish firmly the responsibility for taking these steps.

Secondly, it may be that confidence on international cooperation agreements could be built over time if the immediate focus is on questions of managerial and operational interconnectedness with a view to dealing with the financial considerations once these have been addressed.

While the Financial Stability Board ("FSB) is making progress on international cooperation on resolution of multinational financial organizations, no one expects this issue to be resolved soon. Nevertheless, we firmly believe that international arrangements to cover managerial and operational connectedness are significantly easier to fashion because their financial costs can either be avoided by taxpayers or either relatively modest. So, for example:

- the managerial interconnectedness risk could be handled by an international agreement that no host country managerial changes would be required by a host country regulator without consultation with home country supervisors; and

- operational interconnectedness risk could be largely contained if regulators could either (a) set out agreed rules on the structure of, and continued access to, operational subsidiaries so that progress can be made in this complex area or (b) as a backstop, agree that they will use their powers (where allowed) to maintain intra-group services and support provided that the underlying banks continue to pay the providing banks or group companies for these services – without the taxpayers taking any responsibility for these costs.

If these agreements are reached before a crisis occurs and the burden of costs is clear, a country regulator can view any mutual commitments in these arrangements as a low-cost insurance policy, rather than as an accommodation to or from another country regulator <u>per se</u>, which might otherwise conflict with any requirements to focus on its own national interests.

If the Board could focus efforts in the international regulatory community on these two less fraught aspects of an international resolution framework, we believe that it may have a beneficial effect on international efforts regarding the allocation of financial risks. However, we recognise that reaching agreement on financial cooperation is likely to be more problematic given the considerably larger sums that may be involved and the potential exposure of public funds.

If further efforts are to be made on these agreements (which we sincerely hope they will) and, given that it may not be possible for any necessary agreement or measures to be put in place in the very short term (i.e., before the Proposed Rules are finalised), it might also be appropriate for there to be scope in the Proposed Rules for the relevant portions to be disapplied once any agreement has been reach which satisfies the underlying concerns held by the Board.

4. Considerations from a Change in International Resolution Models

If these options do not bear fruit and there is to be a change in the International Resolution Model, there is a further issue to consider. Moving the global financial framework to a more subsidiarized model will require a major adjustment to the mechanisms by which transactions are undertaken cross-border and international risks are hedged. For example, at present, risks taken on in one country (say, a New York-based bank hedging euro exposures for U.S. clients) can be offset within the same legal entity through transactions by a branch of the same firm in another jurisdiction (for example, a London branch transacting with a branch of a European bank). But in a new, geographically subsidiarized model, this unseen cross-border risk management process will need to be 'unpacked' into component transactions between geographies and will almost certainly have more capital allocated to it.

But there is also the risk that the mechanisms by which cross-border transactions are undertaken and risks are transferred internationally will be suppressed by a drive to reduce intra-entity and intra-jurisdictional risks for resolution purposes. For example, authorities see resolution issues with remote-booking models by banks, back-to-back transactions within Groups to transfer risks and cross-border inter-bank exposures, even when supported by appropriate margin and collateral agreements. But cross-border financial links are essential so that banks continue to be able to play their part in global transaction flows and associated risk management in support of world trade and the global economy. As a result, we believe that the global regulatory authorities must examine these links and the mechanisms that underlie them to (i) establish a preferred mechanism to support international transactions and then (ii) ensure that it is financially and operationally efficient and manages risks effectively.

C. Impact of the Proposed Rules for HSBC

Having set out some generic considerations resulting from the Proposed Rules, this section considers those matters which are of specific interest to HSBC.

1. Consideration of Financial Condition of the HSBC Group

As noted previously, HSBC operates in the U.S. under a holding company structure which is identical to that of domestic organizations regulated by the Board, and without a U.S. branch of a foreign HSBC bank – a structure which is possibly unique amongst the large foreign banks. Given this, our operations comply fully with local rules for capital, liquidity and funding and the relationship with our parent and affiliates for prudential purposes is on an arms-length basis. Accordingly, we believe that it is entirely appropriate for the Proposed Rules to have less emphasis on the financial condition of the wider HSBC Group when all the key elements are already held in the U.S.

For example, our interpretation of Section VIII: Stress Test Requirements is that the regulations for the U.S. Intermediate Holding Companies set out in VIII (B) would be applied to our existing bank holding company but, since we do not operate a U.S. branch or agency of a foreign bank, there would be no requirement for the U.S. authorities to evaluate the stress-testing undertaken of the parent FBO by the home country supervisor. As there is no direct financial link to the offshore parent (as there would be in the case of a branch), we agree that the risks are very different and can be addressed within the general supervisory regime considering the conditions of the local operations and any issues arising from discussions in the College of Supervisors or Crisis Management Group for the HSBC Group, to the extent that these are relevant to the U.S. operations.

We would also observe, however, that if HSBC did operate a branch in the U.S., we believe the focus should be on the stress-tests for the specific legal entity which is the parent for that branch, rather than for the Group as a whole. Within a banking Group which is structured with separate subsidiaries to facilitate Multiple Point of Entry, there is no fungibility of liquidity and capital so the focus needs to be on the directly relevant legal entity rather than the entire Group. Again, the wider Group considerations could be considered through the College of Supervisors or Crisis Management Group.

But while the Proposed Rules would seem to be appropriately framed for banks without branches within Section VIII: Stress Test Requirements, this approach has not been consistently applied in the case of the Section X: Early Remediation. Our current reading is that mandatory remediation actions could be required of the U.S. operations as a result of a deterioration of the financial condition of the Group irrespective of the financial condition of the U.S. operations and ignoring the fact that, given the absence of a branch, there are no direct financial links between the Group and the U.S. operations other than (a) on arms-length terms as may exist with other banks outside of the HSBC Group, or (b) as an equity shareholder. For example, if the Group were to face a Level 3 (Recovery) event but the U.S. operations were operating with material excess capital, potentially as a result of corporate actions, under the Proposed Rules, the U.S. operations would be unable to distribute such excess capital to its parent, even if that is agreed by the supervisors for the U.S. operations. At the same time, it would be unable to invest that capital in growing the underlying U.S. business as a result of the restrictions at Level 2 (Initial Remediation).

We would strongly suggest that the principles of application set out in Section VIII: Stress Tests Requirements should be carried across to Section X: Early Remediation such that the measures are only tested at the branch parent legal entity level where a U.S. branch exists. For those organisations without a branch, the U.S. Intermediate Holding Company provisions would then be the determinant, supported by the general supervisory regime and drawing on discussions on the wider Group condition, but with no mandatory requirements for intervention at this level. This would also remove the requirement for the calculation of a leverage ratio on the U.S. basis when this would not be a useful measure in considering the specific risks to the U.S. financial system offered by a non-branching FBO.

We recognize that we are currently unique in our structure in the U.S., but we believe that it would be prudent regulatory practice for the Board to plan for a time when several, if not many, foreign banks operate with the same structure as we do. Indeed, in the preamble to the Proposed Rules, the Board explains that "differences between this proposal and the December 2011 proposal reflect the different regulatory framework and structure under which foreign banks operate....". More generally, clarifying the position of FBOs which are fully subsidiarized in the

U.S. (such as HSBC) may encourage a greater number of foreign banks to adopt a fully localised structure.

2. Organizational Structure

Given our locally incorporated structure of many years, HSBC has operated along the lines of a local bank holding company in terms of our management structure. We recognise that we will need to migrate to being considered as an FBO but it would be helpful if we could retain some of the structures which are already established. In particular, we already operate U.S.-based risk committees which are responsible for considering the credit and other risks within our U.S. operations but, in common with most U.S.-headquartered bank holding companies, the responsibility for U.S. liquidity management rests within the Finance function. This is an arrangement which has been sanctioned by our supervisors and which has operated successfully over a number of years.

Against this background, in the context of Section VII: Risk Management, we would ask that the Board considers giving supervisors the discretion to accept adjustments to the FBO Proposed Rules where (i) the relevant bank operates solely through U.S. subsidiaries and (ii) the requirements are in line with those that would be applicable to domestically-owned bank holding companies.

We would be pleased to provide further information or assistance to the Board or its staff. If you should have any questions with regard to the foregoing, please do not hesitate to contact John S. Cassidy, Senior Legal Counsel.

Respectfully,

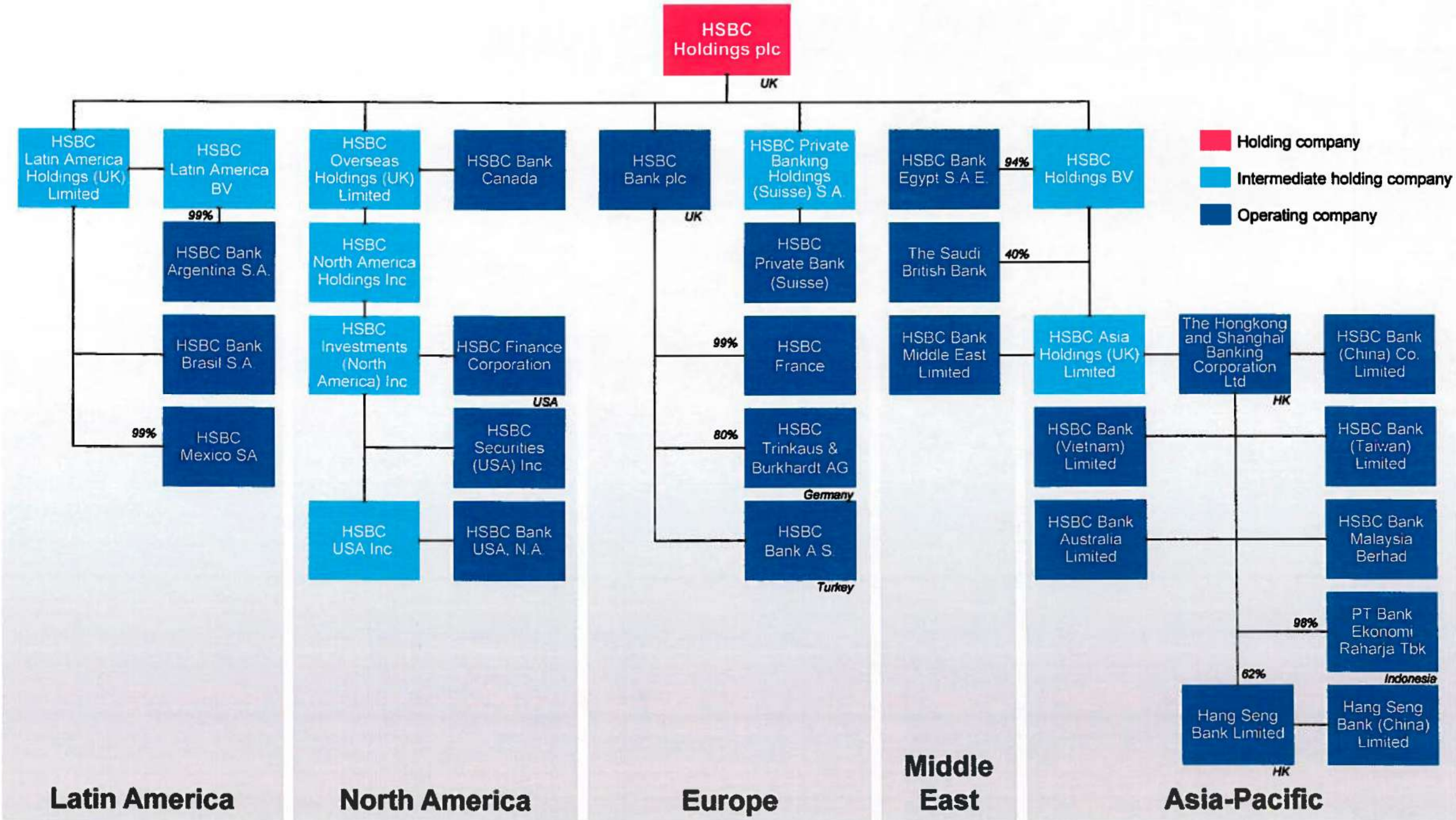
Stuart Alderoty
Senior Executive Vice President and General Counsel

cc: Joseph Abdelnour, FRB Chicago

The HSBC Group

Simplified structure chart

Principal entities in Home and Priority Growth markets



1 All entities wholly owned unless shown otherwise (part ownership rounded down to nearest percent)
2 At 31 December 2012

Appendix 2
Extract from HSBC Holdings plc 20-F in respect of the year ending 31 December 2012

The FSB also determined that recovery and resolution strategies should be developed for all G-SIFIs. Recovery plans set out the actions which management may take during a period of stress to avoid the failure of the firm. Resolution plans are prepared by the authorities based on information provided by firms and set out the actions which may be taken if the firm reaches the point of non-viability. This work is led by the FSA and the Bank of England in the case of the consolidated Group in conjunction with the regulators of HSBC's largest operating entities which make up the Crisis Management Group ('CMG') for HSBC.

In accordance with guidance from the FSB and UK requirements, HSBC has produced a recovery plan for the Group, drawing together many of the actions contained in stress testing and scenario planning exercises conducted within the Group. The recovery plan identifies a series of early warning signals indicative of developing financial stress and establishes triggers which, if breached, would precipitate pre-planned but urgent action from the Group. The plan also contains a series of recovery options to raise additional capital or funding for the Group or individual entities as appropriate.

These options would be reviewed for applicability and feasibility once the cause and magnitude of the financial stress was evident. This recovery plan has been submitted to the FSA and the Bank of England in the UK and through them discussed with the CMG. HSBC has also provided the FSA, the Bank of England and CMG with information for them to determine a resolution strategy for the HSBC Group. The FSB notes that strategies could include a 'single point of entry' or 'top down' approach, where a group is resolved through intervention at the level of the holding or parent company; or a 'multiple point of entry resolution' (as described by the FSB) approach where separate resolution action may be taken at the level of operating subsidiaries.

Given that HSBC primarily consists of a large number of separately incorporated and capitalised banking entities across different jurisdictions, HSBC considers the most appropriate resolution approach for the Group to be 'multiple point of entry resolution'. This decision ultimately rests with the UK authorities in consultation with CMG members. In this scenario, where an individual banking entity within the Group is no longer viable, the resolution of that entity would be the responsibility of that entity's local regulator and resolution authority. In order to support this approach, HSBC is working with the FSA, the Bank of England and its CMG to consider whether there are financial, managerial and operational linkages across the Group which might be barriers to effective resolution. HSBC is also working with the regulators and resolution authorities of a number of its banking entities to develop individual recovery and resolution plans for these entities.