Funding, Liquidity and Capital Management
The new Regulatory Landscape

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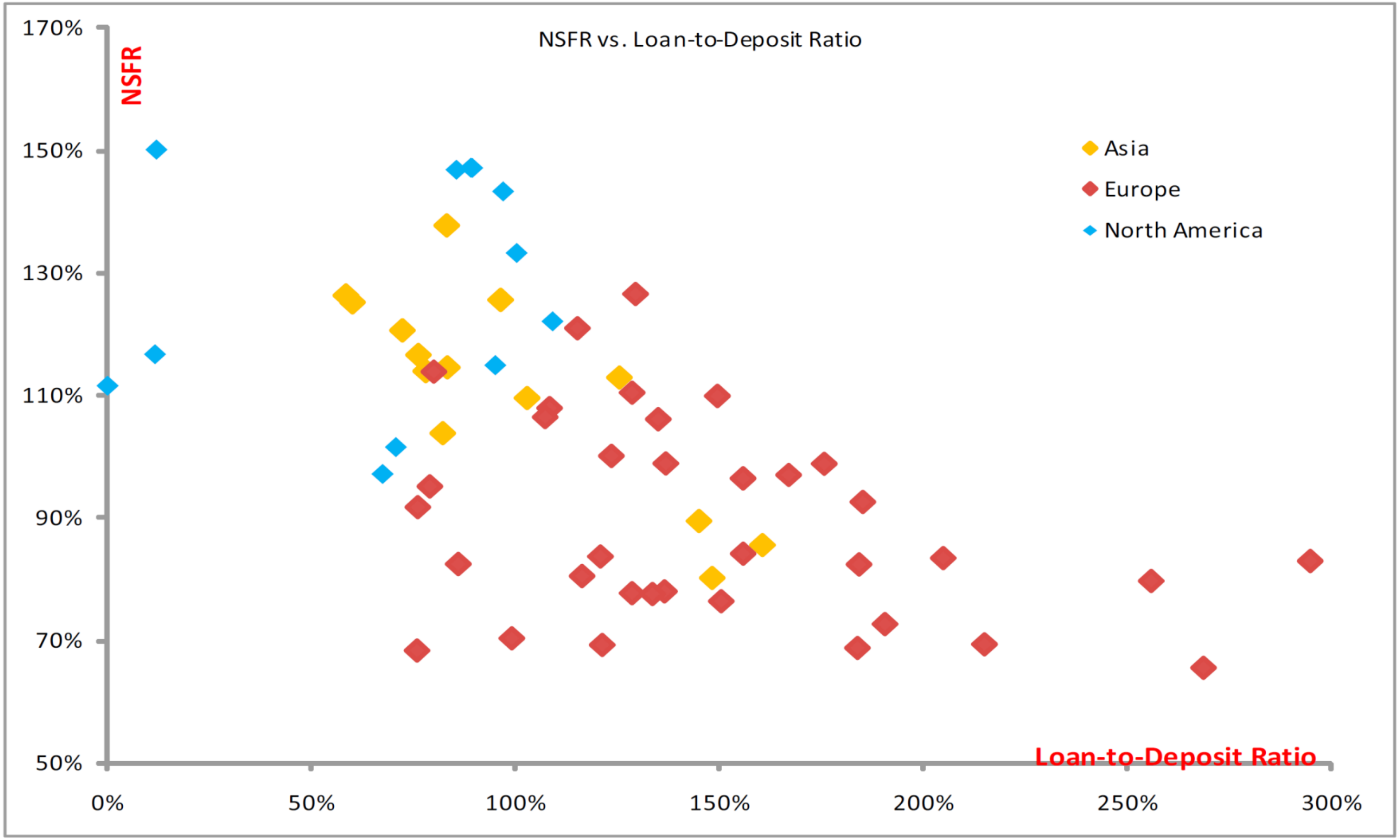
The world's local bank

HSBC's approach to Funding, Liquidity and Capital Management

- Strong capital position with Core Tier 1 ratio > 10.5%
- Conservative liquidity management and limited dependence on wholesale markets with AD ratio < 80%
- Legal entities and geographies required to be self-sufficient for funding and to be able to "stand alone" in case of liquidity stress
- Common Group framework and risk appetite, shaped by our long history of operating in 85 countries
- But not a one-size fits all: tailored to markets in which entities operate

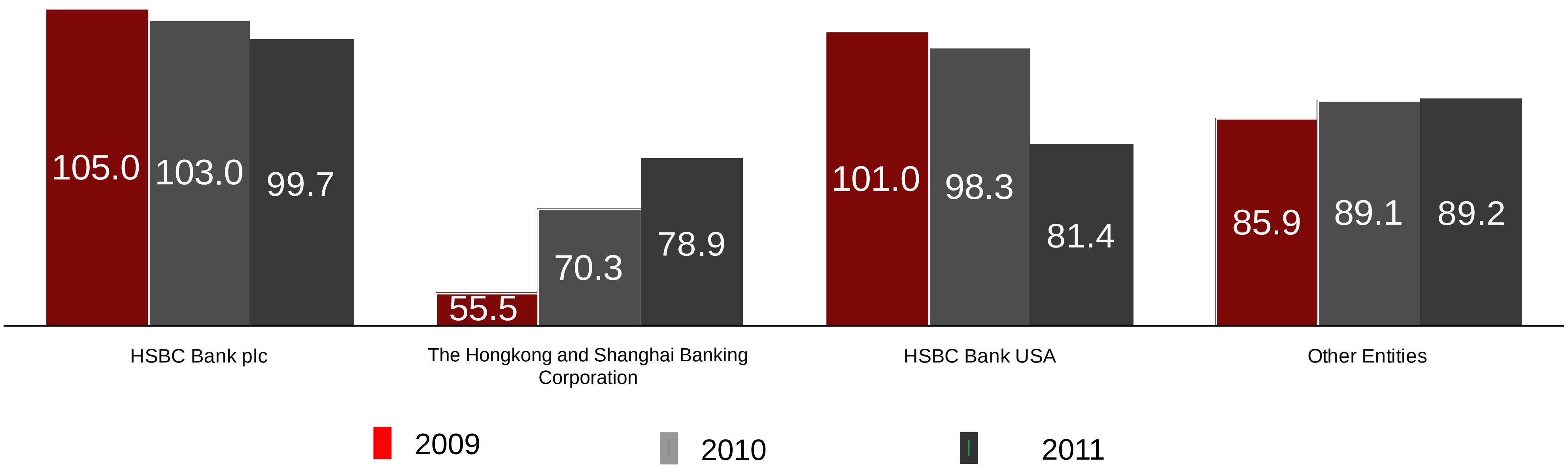
Diversity of Funding Models - Banks



Source: IMF, Nov 2010 - Impact of Regulatory Reforms on Large and Complex Financial Institutions

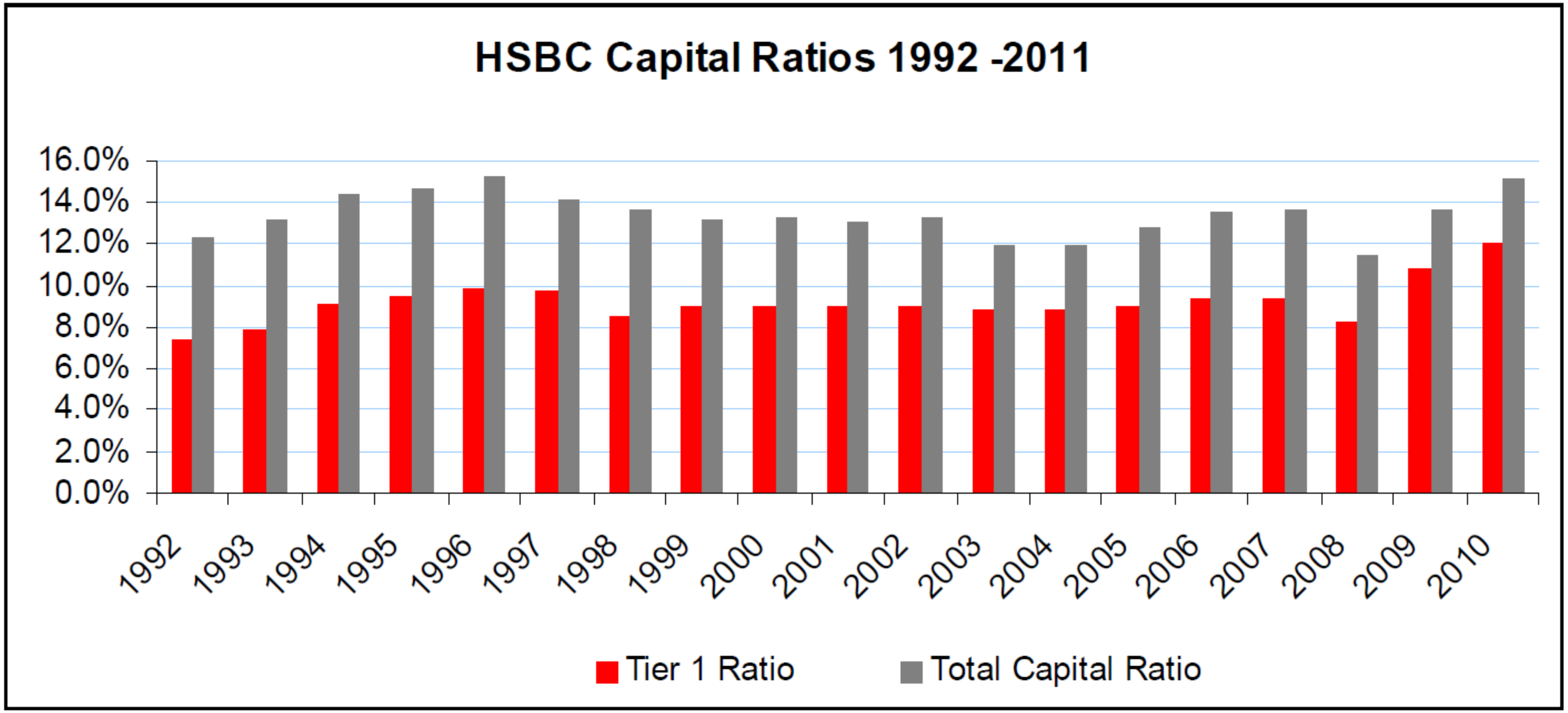
Advances to Core Funding Ratio - HSBC

$$\frac{\textbf{\textit{Advances}}}{\textbf{\textit{Core deposits \& term debt with remaining maturity > 1 year}}}$$



Source: Annual Report & Accounts, 2010 & Interim Management Report 2011

HSBC Capital Ratios 1992 - 2011



Source: Annual Report and Accounts, HSBC Holdings plc

We are reaching the conclusion of a period of dramatic regulatory reform

2007

- Government injections of liquidity
- Initial interest rate cuts

2008

- Further liquidity injections
- Creation of Bail-out schemes (TARP, APS)
- Interest rates cut further
- Impetus from G20
- Development of local regulatory responses

2009

- Initial regulatory reforms to trading books
- Focus on remuneration
- Interest rates cut to near zero
- Economic stimulus packages

2010

- Basel rules on capital, liquidity and funding
- Dodd-Frank Act in US
- Independent Commission on Banking in UK
- Recovery & Resolution Plans

2011

- Translation of Basel rules to CRD4
- Observation period for liquidity framework
- FSB proposals on SIFIs
- Implementation of Dodd-Frank
- ICB conclusions
- Development of EU Crisis Management Frameworks

Liquidity (Basel 3 / CRD4)

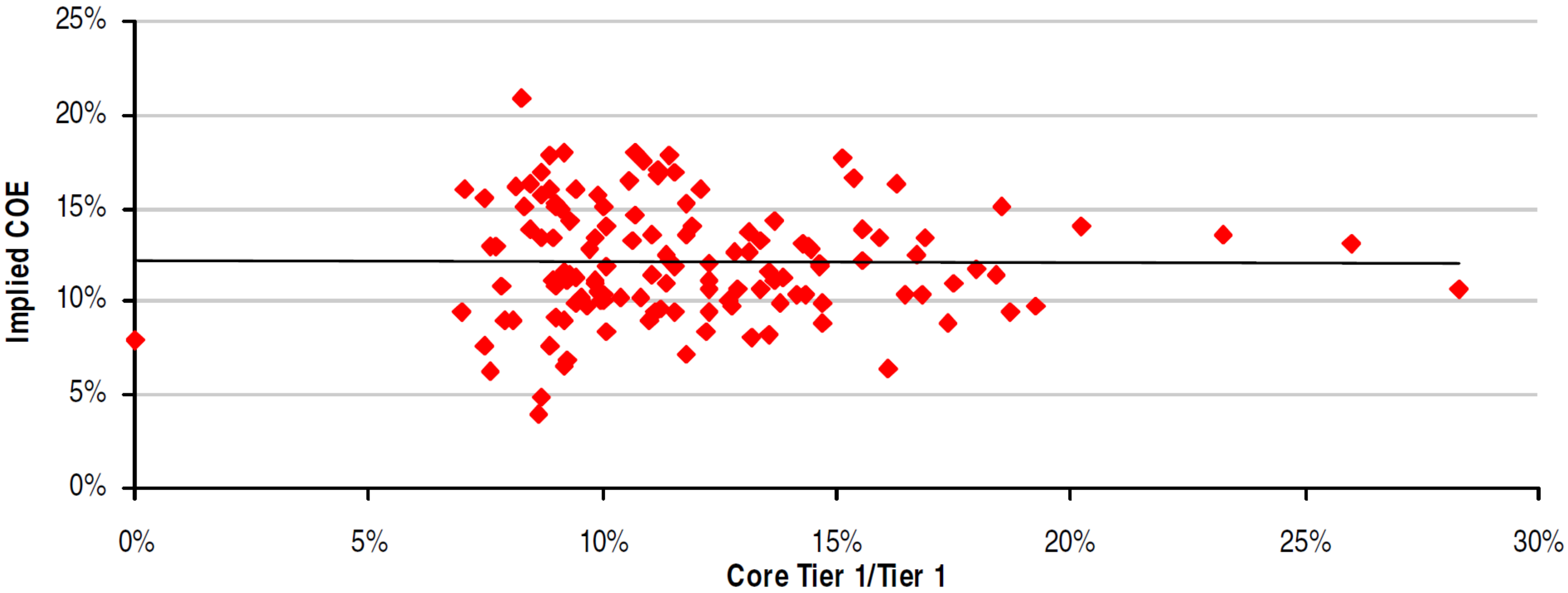
- Very supportive of strengthening liquidity standards
- Funding and Liquidity as important for banks as capital
- Supportive of observation period for LCR in CRD4 to inform
  - A broader definition of liquid assets
  - Clearer guidance on the definition of “operational” deposits
  - Reduced outflow factors in areas such as: SME deposits > Eur1m; committed liquidity facilities
- Solo vs Consolidated reporting
- Intragroup Funding (Large exposures / R&R)
- Disclosure

Capital (Basel 3 / CRD4)

- Supportive of a more globally consistent capital framework, higher quality capital
- Define the linkages between various capital buffers
- Pro-cyclicality of CVA
- Trade Finance
- CoCos

Modigliani–Miller: does it work for banks?

Exhibit 18: Implied COE from current price/ tangible books versus Tier 1 levels (Core Tier 1 for developed market banks)



* COEs based on 2012e, implied long-term growth of 3% for developed markets, 5% for Asia, LatAm, CEEMEA
Source: HSBC research

Which instruments should be bailed in?

- FSB principles:

  (i) Any debt write-down outside of an insolvency procedure must respect the creditor hierarchy; and

  (ii) No creditor should be worse off in resolution than they would have been in liquidation.

- Write down or conversion
- Triggers
- Investor base
- Impact for deposit-funded institutions
- ICB

Challenges in conducting reform

Challenge 1: Rebuilding a regulatory framework after the worst financial crisis of the 1930’s where the origins had multiple causes:

- Poor management
- Poor governance
- Poor supervision
- Public policy goals re housing that had unintended consequences
- Excessive liquidity coupled with low risk free bond rates
- Excessive reliance on modelling versus judgment
- Overreliance on and misunderstanding of ratings

Challenge 2: Create a level playing field so far as possible across countries:

- With different shaped financial systems
- At different stages of economic development
- With differing degrees of central bank/supervisory intervention
- With different growth prospects

Challenges in conducting reform

Challenge 3: In building a new system:

- Build a new framework that limits the risk of repetition of a crisis but at the same time doesn't excessively hamper economic activity
- Build a system that constrains over exuberant credit supply but doesn't choke credit formation to the real economy
- Build a system that promotes good innovation but doesn't allow arbitrage and misaligned structures
- Create a system with the right incentives

Challenge 4: And if it all goes wrong:

- Find a way to mitigate the impact
- That deals with cross border claims
- That avoids contagion
- That recognises that every country is starting from a different place in terms of legal architecture to deal with this

Inputs to a new regulatory system

Macro prudential input / Financial stability measures

Business model / Permitted activities / Funding structure / Administrative measures

Recovery / Resolution frameworks

Settlement architecture / Central counterparties

Intrusive supervision

Liquidity

Capital

SIFI

Most

IMPORTANCE

Least

Conclusions

- Find the right balance between hard-coded rules and macro-prudential policies
- Consistency / level playing field
- Extraterritoriality
- Business model: branch or subsidiary structure
- Role and size of banking system within financial system
- Impact assessment / Observation periods

Thank you

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