

Iain J Mackay
Group Finance Director

30 June 2011

The Sharman Secretariat
c/o Financial Reporting Council
Aldwych House
71-91 Aldwych
London
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Dear Lord Sharman,

Call for evidence ‘Going concern and liquidity risks: Lessons for companies and auditors’

1. We welcome the opportunity to contribute to the development of the Financial Reporting Council (‘FRC’) guidance on going concern and liquidity risk.
2. HSBC is one of the largest banking and financial services organisations in the world with assets of US\$2,598 billion at 31 March 2011. Headquartered in London, HSBC serves customers worldwide from more than 7,500 offices in 87 countries and territories in six geographical regions. HSBC provides a very broad range of financial services and products, including retail banking and wealth management, commercial lending, global banking and markets, private banking, and insurance.
3. In general, we believe the existing FRC guidance on going concern assessments remains an appropriate framework. We also believe that additional prescriptive guidance is unlikely to improve the procedures adopted by companies although there remains an obligation for companies to adapt their procedures to significant changes in business conditions. For example, during the financial crisis, HSBC significantly enhanced its going concern procedures in view of the considerable change in the environment.
4. The limited graduation in the current three category disclosure framework for going concern does not however provide users with information as to the relative ability of companies to continue as a going concern. However, in practice, it is difficult to see what additional disclosures could be provided or additional categories introduced that would enhance users’ understanding.
5. Additional narrative disclosures, such as an explanation of how directors gained comfort over the going concern assumption or the factors that could affect a company’s ability to continue as a going concern may in practice become routine or ‘boilerplate’ in nature, providing users with little additional information. Numerical disclosures, such as liquidity stress test results, are equally difficult to make meaningful and run the very considerable risk of being self-fulfilling. Standardised stress test disclosures do not make adequate

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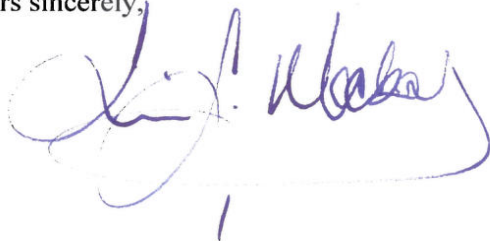
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allowance for variations in business models and markets, and may cause investors to make misleading comparisons between companies. The consequences of investors misinterpreting such information could be very serious.

6. While disclosure of the results of internal stress models would take account of variations in business models and markets, disclosures would be different for each company, making comparison difficult. Companies are likely to carry out many different stress tests and any disclosure would require careful explanation in the context of each scenario and the assumptions used, which could result in disclosures of undue length and complexity. It is difficult to see how such disclosures could be provided without the publication of commercially sensitive information. Furthermore, we believe that the greatly expanded disclosures provided under the Pillar 3 process provide information in sufficient granularity to enable investors and analysts to carry out independent assessments of how risk and capital requirements might change to risk scenarios which in their judgement might arise.
7. Nonetheless, we acknowledge that investors and other users of financial information feel that the disclosures made prior to corporate failures may not have adequately explained the risks involved. As such we believe it would be justified for the FRC to undertake a detailed study of companies that have failed, including an analysis of whether the lack of disclosure was due to any weaknesses in the current framework or to the application of the framework in practice. Lessons learned could then be used to provide additional guidance or help improve the application of the current requirements.
8. Finally, we note that the call for evidence appears to be written largely from the perspective of banks and much of the terminology reflects this. Going concern is an issue for all companies and the types of procedures and disclosures necessary will vary accordingly. The final guidance should reflect this diversity to ensure that it is relevant.
9. Our responses to the specific questions are attached in Appendix A. Please note, we have not responded to question 11 as it addresses the auditor's assessment of going concern.

Yours sincerely,



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Appendix A

Transparency of going concern and liquidity risk

1. What combination of information about:

- **the robustness of a company's capital;**
- **the adequacy of that capital to withstand potential losses arising from future risks; and**
- **the company's ability to finance and develop its business model.**

would best enable investors and other stakeholders to evaluate the going concern and liquidity risks that a company is exposed to? How effectively do current disclosures provide this information?

10. We are unclear as to what is meant by 'the robustness of a company's capital'. The term implies more than just the 'adequacy' of capital and could be interpreted as a qualitative measure. We set out below our comments on the current capital disclosures under International Financial Reporting Standards ('IFRS's) and other requirements which are relevant in this regard.
11. IAS 1, 'Presentation of financial statements', requires disclosure of information necessary to evaluate the objectives, policies and processes for managing capital including summary quantitative data about the amounts managed as capital. However, the disclosure of capital ratios or other quantitative information is not required.
12. There are no requirements to disclose the results of capital stress tests in published reporting. The disclosure of the results of the current European Banking Authority ('EBA') capital (solvency) stress testing looks to have become an annual exercise and the Prudential Regulation Authority ('PRA') has announced that its regulatory regime will involve more stress testing, the results of which may also be disclosed.
13. While we support the standardised stress tests and the publication of the results for such tests where they address capital and solvency, it is important that the regulatory bodies coordinating such exercises and disclosing the results of such tests should carefully and transparently communicate the purpose and bases underpinning such capital stress tests. This is crucial so as not to cause investors to make misleading comparisons between banks. Furthermore, a strong capital position will not necessarily mitigate liquidity risk. There are many recent examples of banks that had strong capital positions yet suffered severely, or even failed, from a lack of liquidity. We are strongly against the publication of the results of liquidity stress tests as so doing may create self-fulfilling prophecies.
14. Standardised, inflexible liquidity metrics, such as those promoted by Basel III, do not make adequate allowance for variations in business models and markets. In times of stress such disclosures may exacerbate rather than prevent a crisis. For these reasons, both we and the industry in general are concerned about the unintended consequences of

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disclosing Basel III measures before such time that the measures have fully evolved and are calculated in a more meaningful way.

15. While disclosure of internal stress models would help to take account of variations in business models and marks, disclosures would be different for each company, making comparison difficult. In addition, each company is likely to carry out many different stress tests and any disclosure would require careful explanation in the context of each scenario and the assumptions used, which could result in disclosures of undue length and complexity. It is difficult to see how such disclosures could be provided without the publication of commercially sensitive information.
2. **What type of disclosures (if any) have been made in the market place outside annual and interim corporate reports about current stresses being experienced by the company and about the management of those stresses? How do these disclosures interact with the requirement to disclose principal risks and uncertainties in the Business Review and the required disclosure on going concern and liquidity risk in the annual and interim financial statements?**
16. HSBC provides extensive disclosures on capital and risk within its Pillar 3 document in line with the current requirements under Basel II. These disclosures are separate from those made in the annual and interim reports and the basis of preparation of the Pillar 3 disclosures differs from that for financial reporting purposes.
17. Furthermore, we believe that the greatly expanded disclosures provided under the Pillar 3 process provide information in sufficient granularity to enable investors and analysts to carry out independent assessments of how risk and capital requirements might change to risk scenarios which in their judgement might arise, addressing some of the issues raised in question one. In addition, HSBC also published its exposure to certain countries in the Eurozone area following the EBA stress testing exercise in 2010. As mentioned above, the EBA may publish stress test results on an annual basis going forward. This is changing the landscape in this area to the extent that an EU regulatory body is now publishing a stress test analysis of the Group outside the normal reporting cycle. Numerical disclosure of exposures to certain countries in the Eurozone area was subsequently made in both our interim and annual reports.
3. **Are there any barriers within the current corporate reporting environment to companies providing full disclosure of the risks associated with going concern and liquidity both within and outside the company's annual and interim reporting? Are there any changes that might be made to encourage companies to give fuller and more transparent disclosures in this respect?**
18. Transparent disclosure in financial statements is a key factor in maintaining market confidence. There has been a marked improvement in financial reporting in recent years with the development of IFRSs. This has resulted in better transparency for investors and other users of financial statements. While improvements have been made, most notably

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through IFRS 7, 'Financial Instruments: Disclosures', the disclosure requirements within IFRSs when combined with other statutory and regulatory requirements can result in financial reports of daunting length and complexity. There is a need to assess the framework of disclosure requirements as a whole to establish a principle-based approach which aims to provide useful information in a format that is readily accessible and understandable. This may result in more focus on key risk exposures and less of a disclosure 'tick box' mentality and may help ensure that accounting and regulatory disclosures do not conflict with one another, which would be confusing to investors.

- 4. Given the current measurement, recognition and disclosure requirements of International Financial Reporting Standards (IFRS), how effective are IFRS financial statements in enabling stakeholders to evaluate the robustness of a company's capital in the context of the going concern assessment? Are there any changes that could be made to these requirements that would better enable them to do so?**
19. Although significant improvements to risk disclosures have been made in recent years, in particular, the disclosure of financial risks through the development of IFRS 7, financial statements are by their nature focused on historical data and are therefore limited in their ability to provide information in the context of the going concern assessment. IAS 1 requires management to make an assessment of a company's ability to continue as a going concern and to prepare financial statements on a going concern basis, but there are no disclosure requirements which specifically address the assessment.
20. As highlighted earlier, the current capital disclosures provided in accordance with IFRSs are also limited. While detailed information is provided on the composition and amount of capital, this information is at a point in time and not subject to the results of a sensitivity analysis. Metrics such as capital ratios are not required to be disclosed.

Company assessment of going concern and liquidity risk

- 5. What processes are undertaken by directors in making their assessment of whether the company is a going concern when preparing annual and half-yearly financial statements?**
21. The procedures carried out reflect the 'Going Concern and Liquidity Risk: Guidance for Directors of UK Companies 2009' published by the FRC, the Listing Rules of the Financial Services Authority ('FSA') and IAS 1. The procedures consist of the assessment of key points arising from a review of the Group Rolling Operating Plan ('ROP'), capital ratios and cash flow forecasts for the Holding Company Group, and the receipt of formal going concern confirmations in respect of key risk areas from the relevant Group General Managers.
22. Management reviews the appropriateness of the procedures and modifies the existing procedures when necessary. For example, during the peak of the financial crisis further

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work was carried out on the possible stress events which could have impacted the bank's liquidity, funding and capital position. The rigour of the analysis assisted in supporting the going concern presumption and confirmed that our existing liquidity risk management framework was appropriate.

- **Which records and information are referred to in making this assessment?**

23. The evidence reviewed includes, but is not limited to:

- Critically reviewing the ROP which takes into account reasonable macroeconomic assumptions and targets for growth and cost control;
- Verifying that principal Group subsidiaries comply with the bank's liquidity risk management framework;
- Confirming that HSBC has satisfactory short-term debt and long-term debt credit ratings;
- Reviewing information on the credit quality of HSBC's loan portfolios, debt securities portfolios, derivative exposures and concentrations of credit risk and exposures to major customers;
- Considering long-term interest and foreign exchange rate exposures with liquidity aspects of operations;
- Performing stress test analysis to understand the potential impact a severe macro-economic downturn scenario would have on profitability and capital;
- Confirming that there are no material liabilities of the Group or major subsidiaries as a result of threatened litigation for which provisions are inadequate; and
- Performing Group reverse stress tests for both solvency and liquidity and assessing the plausibility of such a scenario materialising within the going concern assessment period.

- **What type of model does the company use to develop scenarios to stress-test the assumptions that have been made when making this assessment?**

24. HSBC uses a range of stress tests to support the going concern assessment, including capital and liquidity tests. For example, our liquidity risk framework requires our operating companies to project cash flows by major currencies under various stress scenarios and consider the level of liquid assets that it is necessary to hold in relation to these scenarios. As the main test is an idiosyncratic event, it is not possible to use historical evidence of depositor behaviour. Rather, expert judgement is applied using a conservative overlay. Standard stress tests are developed, with the severity of the test being determined by the perceived inherent risk of the operating company. In addition, each major operating company must also develop their own stress tests based on local factors.

25. Operating companies are also required to perform 'reverse stress testing', as required by the FSA, to highlight those scenarios under which the company must test its business plan

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to the point of failure and take appropriate action should the risks of such failure be deemed to be unacceptably high.

- **What types of risks are included in the going concern assessment: financial, strategic, operational, other? How are these presented in the assessment?**
26. The going concern risk assessment is in effect an enterprise wide risk assessment. The evidence reviewed by management in assessing going concern takes into account financial, strategic and operational risks as well as macro-economic assumptions. The risks considered are those identified through our risk management processes and are analysed in the context of the overall risk management framework.
- **What is the role of the audit committee and risk management committee (where one exists) in this process and what inputs do they receive in order to carry out this role?**
27. The Group Risk Committee to the Board ('GRC') receives information on key liquidity and funding measures and makes key decisions in relation to these measures and their limits. The GRC also reviews and approves the liquidity risk appetite of the Group. Furthermore, the GRC also actively reviews and challenges stress scenarios and results, including the reverse stress test analyses.
28. The Group Audit Committee receives a summary of the analysis performed and confirmations received to support the going concern assumption. This sets out the factors considered and highlights the FRC, FSA and IFRS requirements. This is reviewed by the Committee and additional questions are raised as necessary.
- **What impact has undertaking the going concern assessment had on planning and management of the company?**
29. The enhancements to the going concern process as a result of market turmoil have been incorporated into the ongoing planning and risk management of HSBC. The results of the work performed have been fed back into the ROP process to support cash flow forecasts and to evaluate 'upside' and 'downside' scenarios. In addition, the work performed led to an enhancement of stress testing and reverse stress testing.
- **How has the assessment of going concern and liquidity risks been incorporated into other aspects of company stewardship and reporting?**
30. The going concern assessment is an integral part of the company's stewardship. Our liquidity framework requires liquidity self sufficiency based on the stressed assumptions used in our assessment.

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- **How effective is this assessment in addressing the robustness and adequacy of a company's capital and its ability to continue financing and developing its business model? What, if any, improvements could be made?**
31. The going concern assessment represents one process in the bank's existing risk management framework. It is a regular process carried out by management when preparing annual and interim financial statements. The capital management process is articulated in the annual capital plan which is drawn up with the objective of maintaining an appropriate and optimal amount of capital. The assessment undertaken by management is detailed in our response to question five above.
- 6. What is different about the review of going concern when raising capital compared to the annual going concern assessment undertaken for accounting purposes? Could some of the different procedures be used in the annual accounting and audit assessments?**
32. When raising new capital, it is possible to draw a distinction between raising debt capital and raising equity capital. The decision to raise debt capital in the normal course of business would not trigger a formal review of going concern, whereas in the case of an equity raising, a highly detailed and thorough examination of the company's going concern status is required supported by a working capital memorandum, which is more extensive than the annual going concern assessment. Furthermore, a reporting accountant's review of this assessment would be required.
33. However, the substance of the process of undertaking a review of going concern when raising equity capital is not significantly different from the annual going concern assessment although it is likely to be more intensive. HSBC's going concern process could be extended to support a working capital assessment. In both circumstances, a review of the business on a forward-looking basis together with an assessment of the cash, liquidity and capital position of the company are examined in detail.
- 7. Does the company assess future cash flows and liquidity on a regular basis throughout the year? If so, how regularly is this done and is the information used any different to that used in the annual and half-yearly assessment for the purpose of preparing financial statements?**
34. We assess future cash flows and liquidity of our bank operating companies on a continuous basis, both under business as usual and under stressed conditions. The banks' cash flow projection is considered at the Group's Risk Management Meeting every month and also during the annual and half-yearly assessment of going concern. Furthermore, as part of our internal liquidity management framework, a number of measures have been developed to monitor liquidity and funding risks across the Group. Those measures include those reported in annual and half-yearly financial statements, and a number of other internal liquidity measures.

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- 8. To what extent and how do directors assess the viability of a company over the course of its natural business cycle?**
35. The severe downturn macroeconomic stress test and the reverse stress test cover a 3 to 5 year period and seek to capture the effects of the business cycle. The assessment framework is both quantitative and qualitative, and is supplemented with regular monitoring of our 'Top and Emerging Risks' across the Group. The emerging risks category provides insights into risks which could evolve into larger issues affecting the going concern assessment.
- 9. The current model of disclosure identifies three categories of company. What sort of behaviours does this model drive? Is there a different model that might be useful? Would more guidance on the application of the current model be helpful?**
36. We believe the existing model is clear. We recognise that the limited graduation in the three categories of going concern does not provide users with information as to the relative ability of companies to continue as a going concern. However, in practice, it is difficult to see what additional disclosures could be provided or additional categories introduced that would enhance users' understanding. There is a risk that more granular categorisation may cause confusion to investors and would be subjective to apply in practice. If there is significant doubt about a company's ability to continue as a going concern, this should, in theory, already be captured through the existing categories.
- 10. In your experience, what issues have resulted in a heightened focus on the assessment of going concern? What was the nature of the risks that gave rise to these circumstances? Had these risks been identified in advance, and if so, how?**
37. The dislocation of the financial markets during the crisis affected HSBC less than some other institutions due to the execution of an effective and prudent risk management framework. HSBC placed limited dependence on the wholesale market for funding as it had a strong, well-diversified funding base; it also benefited from a strong capital position during this period.
38. In response to the widespread deterioration in the markets for securitised and structured financial assets and consequential disruption to the financial system that commenced in mid-2007, we re-evaluated our existing risk management framework to confirm that it remained appropriate for the current conditions. As a result, as specified in response to question five, additional procedures were performed which supplemented the existing going concern process and confirmed the appropriateness of our existing liquidity risk management framework.

Feedback on the Guidance for Directors of UK Companies in respect of going concern and liquidity risk

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12. Do you believe that amendments to the Guidance for Directors of UK Companies in respect of the going concern and liquidity risk would be helpful? For example:

- **Guidance for directors on disclosures does not specify language to be used, whereas auditors use more standardised wording. Is this helpful?**
- **Is there a need for a clear boundary between the three types of company?**

39. The existing guidance identifies a clear boundary between the three types of companies. Providing standardised wording for companies to use in their financial statements could be more meaningful for users of the financial statements. Requiring companies to use standardised language could help avoid confusion, restrict the ability to disguise potential issues, and enhance consistency across companies.

13. Are there any other views that you would like the Panel of Inquiry to take into account?

40. The answers above address the key issues which we would like to raise to the inquiry.