26 October 2019

Dear Sir/Madam,

HSBC welcomes the opportunity to respond to the IVSC Financial Instruments Agenda Consultation. HSBC supports IVSC initiatives to promote standardisation and best practice with regard to the valuation of financial instruments.

A. General Comments

1. Are the financial instruments valuation topics described in this ITC areas for which there is potential for significant improvement as compared with IVS 2017?

HSBC observes that focus on valuation and its associated controls has recently expanded both in terms of complexity and the level of minimum expectations. Multiple valuations are now required notably, Financial reporting, regulatory, exit price in a solvent wind down context, valuation in recovery, and stress. Furthermore, IBOR transition is increasing the complexity of the valuation landscape. It is sensible and opportune to update IVS 2017 in light of these fundamental changes. Areas highlighted in the ITC are obvious points to consider.

2. What is the priority of addressing each financial instrument valuation topic?

The selected topics are structural to the valuation framework and with the exception of IBOR replacement, are not the subject of any specific market change or event. We have no strong views on the priority.

3. What should be IVSC’s next step to address each financial instrument valuation topic? For example, should IVSC issue a discussion paper, an exposure draft, or take some other action?

Given the diversity of practice, operating models and interpretation in the Industry, an iterative approach is advocated and collecting feedback from a broad range of market participants is deemed to be a necessary step before publishing any final standard. A discussion paper would be the first step towards this.
B. Detailed questions

Question 1: To what extent is the scope of revisions to IVS 500 as outlined above appropriate?

The proposed scope of revision does reflect issues and challenges that the Industry has been tackling since 2008 and is therefore sensible.

Question 2: Should IVS 500 keep the current definition of a financial instrument? If not, should the definition be removed or revised? If revised, what should the definition be?

Whilst the IVSC definition of Financial instruments (“contract that creates rights or obligations between specified parties to receive or pay cash or other financial consideration”) is both understood and sensible, we note that the wording slightly differs from the accounting and regulatory definition (“any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity”). IVSC should clarify the rationale for adopting a different language and if it implies that there should be different interpretations.

Question 3: When considering guidance on governance as it applies to financial instruments, to what extent should detail be provided on the areas outlined in the previous section: management and others roles and responsibilities, segregation of duties, and valuation risk and escalations through the chain of command?

Guidance on governance should aim to (i) articulate the operational risk framework (3 lines of defense principles) and (ii) apply the “Principles for effective risk data aggregation and risk reporting” (BCBS 239) to the valuation framework of financials instruments.

Question 4: When considering guidance on data as it applies to financial instruments, to what extent should IVS standards address measuring the quality of data, exercising judgement in the use of data, and producing valuations when insufficient data are available?

HSBC believe that Data accuracy and reliability assessment is indeed a critical component of the valuation framework: notably with respect to (i) determining observability and levelling, (ii) assessing modelability (FRTB) and (iii) uncertainty measurement (PVA). Enhanced Internal Management information and external disclosures are required to inform stakeholders of the degree of subjectivity valuations are exposed to. As the Industry would benefit from standardization, we support any IVSC initiative that conceptualize and articulate data quality requirements and subsequently promote consistent best practice across market participants.
Question 5: When considering guidance on methods and models as it applies to financial instruments, to what extent should details be provided regarding how methods and models are selected, validated and risk managed?

HSBC recommends that the guidance be consistent with both regulatory (SR1107, ECB guide to internal models, BOE Model risk management principles for stress testing) and auditor requirements. As the range and scope of methods and models used in the valuation space is quite wide and diversified (risk neutral pricing, reserving through P&L or capital, levelling, P&L deferring and amortization, mapping and grouping, risk bucketing, statistical quantification, machine learning) guidance should probably remain principle-based and not be overly specific.

To what degree should the evolving market practices, such as XVAs, be addressed?

HSBC is of the view that the IVSC guidance should be as generic as possible and not product or market event dependent. That said, illustrative boxes based on real cases (CDOs crisis, Funds Liquidity issue, Ibor transition, CCP basis) may be very useful and provide some real life proofs of concept.

Question 6: When considering guidance on controls as it applies to financial instruments, to what extent should the IVS detail controls needed for the end-to-end valuation process?

Controls are indeed forming an increasingly critical part of the valuation framework: a holistic list of type of controls are now required to support valuation output: completeness substantiation, evidence of review, oversight and challenge, sign-off, consistency and reasonableness checking, trend analysis, and reconciliations between primary valuation system and the ledger. However, detailed operationalization of such controls should not be part of the Guidance.

Question 7: Are there additional gaps in the standards that need to be addressed? If so, what are they?

Although additional and more specific valuation topics could also benefit from better clarification and standardization (E.g. illiquidity, concentration, observability), we agree that the gaps identified should be prioritized and offer enough tangible deliverables to the industry.

Question 8: Do you use IVS 500 today? If so, how is it used?

IVS 500 is part of our Valuation reference database amongst other valuation accounting, regulatory and Industry guidelines. Valuation stakeholders and practitioners can easily refer to best practice guidelines and make judgements when required.

Question 9: Would your organisation like to contribute to this process? If so, who would you nominate to be considered?

HSBC has historically been actively participating in IVSC working groups and is looking forward to contributing to new valuation standards.