To,
The Chair,
IVSC Financial Instruments Board,
International Valuation Standards Council.

21st April 2021


Dear Gavin,

Please find HSBC’s feedback on the IVS 500 Financial Instruments Exposure Draft issued on 11 December 2020 below.

HSBC welcomes the opportunity to respond to the IVSC Exposure Draft on Financial Instruments Valuation. HSBC supports IVSC initiatives to promote standardisation and best practice with regard to the valuation practices of financial instruments.

Objective

Q1. Do you agree with the proposed objective? Why or why not? If you agree with only parts of the proposed objectives, please specify what you agree and disagree with. If you disagree with the proposal, please explain what you propose instead and why.

HSBC Response: We agree with the proposed objective, noting that The Standard seeks to supplement current accounting standards and set a framework establishing best practice for the valuation of financial instruments. Valuation of financial instruments is a complex topic covering a myriad of instruments and multiple end users; care should be taken to ensure that the objectives are set out flexibly to provide guidance and establish best practice.

Q2. The Exposure Draft is focused on the requirements that have to be met for two elements, Governance, and Data, of the proposed standard in order for an entity to arrive at a fit-for-purpose valuation of financial instruments. Do you agree that the requirements are clear, complete and provide adequate guidance to ensure compliance? Why or why not? If you agree with only parts of the requirements, please specify what you agree and disagree with. If you disagree with the requirements, please explain what you propose instead and why. If you think the requirements are incomplete, please explain what you propose should be included and why.

HSBC Response: We welcome the exposure draft requirements that have been set out for Governance and Data and agree that the draft is detailed in its approach. Specific comments have been made on the individual elements as part of this response and follow below.

Scope

Q3. Do you agree with these proposals? Why or why not? If you agree with only parts of the proposals, please specify what you agree and disagree with. If you disagree with the proposals, please explain what you propose instead and why.
HSBC Response: We agree with the proposal setting out the scope of The Standard.

Definition

Q4. Do you agree with these proposals? Why or why not? If you agree with only parts of the proposals, please specify what you agree and disagree with. If you disagree with the proposals, please explain what you propose instead and why.

HSBC Response: We agree with the definitions as set out in The Standard. We propose some minor amendments to lend clarity to the definitions.

For 30.1 we propose the following amendment: “A **fit-for-purpose valuation** is one that is produced, controlled and used in compliance with the requirements of this Standard at a given valuation date, as long as the gaps in compliance are assessed, recognised and documented. Fit-for-purpose **valuations** include **valuations** for financial, tax and regulatory reporting.”

Q5. Do you agree with these proposals? Why or why not? If you agree with only parts of the proposals, please specify what you agree and disagree with. If you disagree with the proposals, please explain what you propose instead and why.

HSBC Response: We agree with the definitions as set out in The Standard. We propose some minor amendments to lend clarity to the definitions.

For 30.6 we propose the following amendment “**Valuation risk** is the risk that a financial instrument **may be** mis-valued for its intended use. Factors contributing to valuation risk include the complexity of the financial instrument, incomplete or inaccurate data **including market or model input data**, market instability or lack of liquidity, financial modelling uncertainties and inadequate infrastructure, processes and controls. The level of valuation risk will vary by the type of financial instrument being valued and the processes and controls that the entity valuing the financial instrument has implemented.”

For 30.7 we propose the following amendment “**Valuation uncertainty** is a component of valuation risk and is the possibility that there exists a **range of plausible values** for a financial instrument” and therefore not necessarily equally reasonable.

For 30.8 we believe that it would also be beneficial to include wording around “Risk Tolerance” and “Risk Mitigation” and clarify the difference between firms having open risk but putting control measures in place to mitigate the effects, and having open risk but with a framework to measure and accept the risk.

“**Valuation risk appetite** is the level of valuation risk that an entity is prepared to accept, or tolerate **where unmitigated**, in pursuit of the objective of developing a fit-for-purpose valuation before action is deemed necessary to reduce this risk. The valuation risk appetite **and tolerance** will be determined based upon the intended use of the **valuation**.

Similarly, for 30.9 “**Proportionality**”, we believe that the definition would benefit to include terminology around tolerance and risk mitigation.

Governance

Q6. Do you agree with these proposals? Why or why not? If you agree with only parts of the proposals, please specify what you agree and disagree with. If you disagree with the proposals, please explain what you propose instead and why.

HSBC Response: We broadly agree with the proposals but wish to note the following:

- For 50.1 In developing **valuations** of financial instruments, the entity **should be in a position to** evidence the processes and governance that has occurred.
- For 50.2 while it should be clear that systematic processes are desirable, there can be legitimate exceptions due to regional, regulatory and diverse market practices. However, these differences should be explicitly noted and be subject to governance and documentation.
- For 50.3.3, we believe there is merit in aligning the definitions to existing terminology and accounting levelling classifications that exist. Typically, financial instruments with a large market
component would be deemed to be Level 1, and transactions which are marked to a model would be deemed to be level 2. We see “Judgemental components” typically as an extension to the model component, where significant uncertainty or un-observability exists, but should be governed and controlled in the same manner as the model component with all the necessary justification provided for assumptions and justifications used.

- For 50.4 just as it is noted that in certain cases it might be appropriate to combine the roles of Challenger and Assessor, it is also plausible for certain roles like a Developer to be split between different sub-functions where the development of the valuation approach could be different to the implementation of controls. Firms on the street typically tend to have separate teams setting the methodology and requirements to those that construct and implement methodology.

- For 50.4 we believe there would be benefit in clarifying the roles in relation to existing terminology, specifically in relation to the Lines of Defence and the span of responsibilities within the different lines of control. Practically, some roles may be duplicated within different lines of defence but on the other hand these may be entirely separate, for example the roles of reviewer and challenger could both be within the 1LOD, but could also cover the Independent Model Reviewer where the role typically sits in the 2LOD. Additional consideration must be given where firms could duplicate the roles across the lines of defence, where the role of challenger and assessor sit in two lines of defence. As such we feel that care should be taken to define the intention of the role in context of the size and complexity of the organisation and the valuation risk, not just for this particular section but more generally for the description of the role holders.

**Data**

**Q7: Par 60.6.2 to 60.6.8 outline the specific requirements for the data-types listed above. Do you agree with these proposals? Why or why not? If you agree with only parts of the proposals, please specify what you agree and disagree with. If you disagree with the proposals, please explain what you propose instead and why.**

HSBC Response: We welcome the comprehensive description of data and its uses in valuations. Care must be however taken to ensure that the standard remains flexible and supports market practice. We believe the standard as set to be viewed as “best practice” which will allow organisations to achieve a high standard rather than a mandated process for a “fit for purpose” valuation. Further comments below.

For 60.5.3 ii and iii “Dynamic data” and “Performance data” definitions should include model parameters that are observed or derived from market data and/or observed over time.

**Q8. Par 60.6.2 to 60.6.8 outline the specific requirements for the data-types listed above. Do you agree with these proposals? Why or why not? If you agree with only parts of the proposals, please specify what you agree and disagree with. If you disagree with the proposals, please explain what you propose instead and why.**

For 60.6.2 we see “internally sourced data” to include market data as they could be derived from external transactions and or derived from transactions to drive model based valuations.

For 60.6.3.1, we see market data as a broader than just market transactions or executable quotes. Market data should be set out to include the above but also includes broker quotes (indicative), generic or standardised quotes (such as interest rate term structures), broker and consensus service providers. We believe that the hierarchy of market data that includes executable transactions but also covers consensus and indicative broker quotes as part of an acceptable hierarchy of market data as defined above is required, and recommends that each firm recognises their hierarchy of market data used for their respective valuations.

Therefore, we feel that for (i) the initial definition as “binding and not indicative” is too restrictive. For (ii) we propose an amendment “that care should be taken to ensure that the relationship between the data provider and the entity does not directly or indirectly control or influence the broker or dealer when used for valuation” and for (iii) the wording to “represent a tight range” is too subjective and some clarity (for example using wording around standard market conditions and reasonable spreads) would be beneficial.

For 60.6.3.2 it is possible that for less liquid products, quotes observed over a longer duration may be used.
Q9. Paragraphs 60.7.1 to 60.7.6 outline the principles for controlling and aggregating data across an organisation. Do you agree with these proposals? Why or why not? If you agree with only parts of the proposals, please specify what you agree and disagree with. If you disagree with the proposals, please explain what you propose instead and why.

HSBC Response: We agree with the proposal setting out the scope of The Standard.

Yours sincerely
Punit Bhatia
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