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To:

The Treasury Select Committee
Houses of Parliament
London SW1A 0AA

The relaxing of ringfencing was 'taxpayer support' for the rescue by HSBC of Silicon Valley Bank UK

Briefing for the hearing on 28th March 2023 of the Governor of the Bank of England and the Economic Secretary to the Treasury

Relaxing of ringfencing was 'taxpayer support' for the rescue by HSBC of Silicon Valley Bank UK

Background

Intense lobbying by the UK tech and fintech sectors resulted in their pocket bank – Silicon Valley Bank UK – not going into resolution over the weekend of 11th/12th March 2023.[1] Instead, it was sold to HSBC for £1. SVB's UK customers in the tech and fintech sectors now continue to burn through the cash from their latest funding round,[2] making losses and not troubling the scorers with any burdensome payments of corporation tax.[3] SVB UK's staff have had their annual £15-20 million of bonuses paid.[4]

The value of this pocket bank has been market-tested – it was £1.

That is about right as far as SVB's major involvement in the fintech sector is concerned. The sector has no revenue streams apart from deductions-from-face-value on card payments, which are taken from the sales proceeds of UK merchants and passed on to UK consumers in the form of higher prices, and from selling on customer data. The sector has acted as a propagator of Authorized Push Payment Fraud, amongst other forms of financial crime to which the recent 'Dear Chief Executive Officer' letter from the Financial Conduct Authority addressed itself.[5] The letter indicates that the sector does not even keep its customers' money safe. To create a nationwide playing field for it, however, UK consumers and business have had their access to cash and branch services truncated.[6]

Business prospects of the sector are very poor

Even with these subsidies to its revenues and with the risks and detriments it imposes on UK consumers and businesses, the sector is not self-sustaining – it is dependent upon regular infusions of Venture Capital funding until a flotation via an Initial Public Offering is carried out.

These sources-of-funds have dried up while the sector's 'cash burn rate' has increased, two major factors in the downfall of SVB UK's US parent.[7] This raises the likelihood of SVB UK's customers going into liquidation, and for those that have borrowed to default on their debts. Lending into the sector is high-risk.

The Financial Conduct Authority acknowledged, in its 'Dear Chief Executive Officer' letter, the high chance that many fintech firms will go under: it requires them to have wind-down plans and remarked that these were currently not sufficiently robust.

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[1] 'Pocket bank': a bank working at the behest of an industry grouping or ecosystem, and owned predominantly by market actors within it, who are also its customers, as both borrowers and depositors

[2] A 'funding round' is the block of money invested by Venture Capitalists at each stage of a start-up's progress to a share flotation or Initial Public Offering. There are normally three or four such rounds before the enterprise goes public, and all the investors and the management cash out

[3] Profits, if there are any, conveniently land on the books of an entity incorporated in the Republic of Ireland, another unresolved Brexit issue

[4] https://www.theguardian.com/business/2023/mar/18/millions-paid-in-bonuses-to-uk-silicon-valley-bank-staff-days-after-1-rescue accessed on 20 March 2023

[5] priorities-payments-firms-portfolio-letter-2023 issued by the Financial Conduct Authority on 16 March 2023

[6] A full explanation of these detriments can be found in http://www.lyddonconsulting.com/capture-a-major-new-paper-on-the-committees-considering-a-uk-central-bank-digital-currency/

[7] https://en.irefeurope.org/publications/online-articles/article/what-are-the-lessons-for-europe-from-the-demise-of-silicon-valley-bank/ accessed on 13 March 2023

Taxpayer support for the rescue of SVB UK

According to the Daily Telegraph, 'Government officials ruled out a FULL taxpayer bailout of the bank' [our capitalization].[8]

The officials did not rule out a partial bailout.

HM Treasury issued a statement saying that ‘no taxpayer money is involved’, but this is not the same as ‘no taxpayer support’, the words attributed to Jeremy Hunt.[9]

The government has relaxed ‘ringfencing rules’ for this deal. That might sound technocratic and peripheral but it is extremely important, and amounts to taxpayer support, without taxpayer money being needed.

Summary of the Technical Annex

The Technical Annex delves into detail of the substance and implications of this relaxation of ringfencing.

Ringfencing protects taxpayers from subsidizing blow-ups in international and investment banking – like this one. The ringfencing regime was constructed over a number of years to ensure that high-risk business was not booked into the UK domestic arms of the major banks (meaning within the ringfence), and did not threaten the safety of balances on current accounts and savings accounts. Instead business classified as high-risk had to be held outside the ringfence - in a separate bank operating at arm’s-length to the UK domestic one, and with its own capital cushion to absorb losses.

SVB UK's business will initially be held INSIDE the HSBC ringfence, in HSBC UK Bank plc. In all likelihood SVB UK’s depositors will diversify their risk and reduce their balances in SVB UK as quickly as they can. SVB UK’s loan book - a high-risk portfolio – will stick, not least because SVB UK was one of the very few banks willing to service the sector. That means that SVB UK and its high-risk loan book will increasingly become funded by the other balances in HSBC UK Bank plc, namely those belonging to UK consumers and businesses.

This situation is exactly what ringfencing was designed to prevent.

The SVB UK loan portfolio will produce credit losses. Those will now be absorbed by HSBC UK Bank plc’s ‘Total shareholders’ equity’ – its loss cushion. The cushion stood at £24 billion on 31/12/21,[10] and SVB’s loan book is about 20% of it.

Losses on the loan book will reduce the creditworthiness of HSBC Bank UK plc, put the money of UK businesses and consumers at greater risk, and make a call on the FSCS more likely, to fund which HM Treasury would have to issue more gilts, for which all UK consumers and businesses are responsible: if taxpayers don’t lose first time around by dint of being depositors into HSBC UK Bank plc, they lose second time around by shouldering a higher national debt.

That qualifies as 'taxpayer support'.

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[8] https://www.telegraph.co.uk/business/2023/03/13/how-project-yeti-rescued-uk-tech-monday-morning-bloodbath/ accessed on 14 March 2023

[9] https://www.politico.eu/article/hsbc-buys-silicon-valley-banks-uk-business/ accessed on 13 March 2023

[10] HSBC UK Bank plc 2021 Annual Report p. 74

Technical Annex on the capital position of HSBC UK Bank plc and its Risk-Weighted Assets

Introduction

The purpose of this Annex is to prove that:

- HSBC's ringfenced bank becomes less secure by SVB's loan book being incorporated into it: this puts the deposits of other customers at greater risk;
- The lending capacity of HSBC's ringfenced bank for mortgages and other types of credit to UK consumers and businesses **could** be reduced, and **will** be reduced if HSBC management believe that the size of the current loan portfolio is as large as the bank can manage, if it is to fulfil its targets for capital adequacy and liquidity;
- If HSBC management believes the bank can deal with the expanded loan book, there is a reasonable possibility that it will produce losses and/or otherwise act as a drag on HSBC's ratios and targets, to alleviate which HSBC will increase the cost-of-credit to other borrowers or reduce interest paid to other depositors.

All the figures are taken from the bank's 2021 Annual Report and Accounts.

SVB UK position within HSBC group and its impact on the balance sheet of HSBC UK Bank plc

SVB UK will remain as a separate subsidiary within HSBC UK Bank plc but this does not make it unique or alter anything in this Annex: 24 wholly-owned subsidiaries already sit within the HSBC ringfence (p. 118).

Once SVB UK sits within the ringfence, any deposits also within the ringfence can be used to fund its business. The assumption is that SVB UK's depositors will withdraw the bulk of their money in order to diversify their risk, and that the main effects of HSBC's takeover will be:

- To reduce HSBC UK Bank plc's cash at the Bank of England by £5bn from £112bn to £107bn;
- To increase the bank's loans by £5bn from £196bn to £201bn;
- That the footings of HSBC UK Bank plc's balance sheet remain the same;
- That the SVB UK high-risk loan book becomes funded with the deposits of UK consumers and businesses – exactly what ringfencing was designed to prevent.

As at 31/12/21, HSBC UK Bank plc's balance sheet could be summarized as follows:

Assets		**Liabilities and Total shareholders' funds**	
Bank of England balance	£112bn	Customer deposits	£282bn
Loans	£196bn	Other liabilities	£40bn
Other assets	£38bn	Total shareholders' funds	£24bn
Total	£346bn	Total	£346bn

This looks like a strong and safe bank, as it should be.

'Total shareholders' funds' of HSBC UK Bank plc under a financial regulation perspective

HSBC UK Bank plc's capital position is not quite as strong as the figure for 'Total shareholders' funds' suggests. This number is all the money on the right-hand side of the balance sheet that is not owed to third-parties. It includes amounts that financial regulators do not count as 'capital' for the purposes of computing how much the bank can lend.

A bank's lending capacity is computed – and its financial strength assessed - in line with a series of ratios with a common denominator, which is the bank's so-called 'Risk-Weighted Assets' or RWAs.

The numerators in the ratios reflect the different types of capital that a bank may have. A bank is permitted to fulfil all the ratios just with the best-quality type of capital, called Common Equity Tier 1. The owner of this type of capital would be the last to be paid out in the event of the bank's liquidation, and their investment would be erased in a 'resolution'. Because the investment in this type carries the highest risk, the investor wants the highest return. For the bank this is the most expensive type so banks choose to take on the other types, whose cost reduces with the investor's lower risk-of-loss.

The other two types can be understood as 'Junior subordinated' – one step ahead of Common Equity Tier 1 in a liquidation – and 'Senior subordinated' – two steps ahead of Common Equity Tier 1 and one step ahead of 'Junior subordinated' in a liquidation.

The lower risk-of-loss for the investor conflicts with the objective of financial regulators to ensure the capital really is there to absorb losses as and when they occur: they are concerned with the degree of tangibility of the capital. Financial regulators have determined that the bulk of the capital must be in the form of Common Equity Tier 1, with top-up buffers of the other two recognised types being acceptable. The aggregate of these three types is called the bank's 'regulatory capital'.

HSBC UK Bank plc's capital position

HSBC UK Bank plc has elements in its 'Total shareholders' funds' that fail the tests of tangibility, such as certain types of reserve, and these elements do not form part of its 'regulatory capital'. For example, a revaluation reserve can fall in value as well as rise. In fact in the market conditions during which a bank's capital may be needed to absorb losses, the assets that rose in value to create the revaluation reserve must be considered likely to fall in value, reducing the revaluation reserve or even creating a revaluation deficit.

Financial regulators have therefore created a scheme, albeit one with some grey areas around its edges, for classifying the elements in 'Total shareholders' funds':

Capital type	Investopedia definition
'Common Equity Tier 1' (CET1)	'a bank's core capital and includes common shares, stock surpluses resulting from the issue of common shares, retained earnings, common shares issued by subsidiaries and held by third parties, and accumulated other comprehensive income (AOCI)'.[11]
'Other Tier 1 capital' or 'Additional Tier 1 capital' (i.e. AT-1)	'instruments that are not common equity but are eligible for inclusion in this tier. An example … is a contingent convertible or hybrid security, which has a perpetual term and can be converted into equity when a trigger event occurs'.
Tier 2 capital	'second or supplementary layer of a bank's capital and is composed of items such as … hybrid interest-bearing instruments, and subordinated term debt'.[12]
Non-qualifying amount	Amounts that are stated within 'Total shareholders' funds' on the balance sheet but which fail the tests for being included in 'regulatory capital'

[11] https://www.investopedia.com/terms/c/common-equity-tier-1-cet1.asp accessed on 2 June 2022
[12] https://www.investopedia.com/terms/t/tier2capital.asp accessed on 2 June 2022

HSBC UK Bank plc's 'Total shareholders' funds' as per p. 74 consist of:

Balance sheet line	Amount
Called-up share capital	£0.0bn
Share premium account	£9.0bn
Other equity instruments	£2.2bn
Other reserves	£7.7bn
Retained earnings	£4.9bn
'Total shareholders' funds'	£23.8bn

The 'Capital Overview' on p. 51 expresses this picture in the terms framed by financial regulators:

Capital Type	Amount
Common Equity Tier 1	£12.8bn
Additional Tier 1 capital	£2.2bn
Tier 2 capital	£3.0bn
Total regulatory capital	£18.0bn
Non-qualifying amount	£5.8bn
'Total shareholders' funds'	£23.8bn

Reconciling HSBC UK Bank plc's balance sheet and its statement of regulatory capital

There is no precise reconciliation between the two pictures, but we can extrapolate that:

1. The 'Share premium account' of £9.0bn constitutes Common Equity Tier 1;
2. The difference of £3.8bn between this figure and the total of Common Equity Tier 1 of £12.8bn is constituted by 'Retained earnings', i.e. appropriated profit;
3. 'Other equity instruments' in the first table are the 'Additional Tier 1 capital' in the second table, and this is confirmed on p. 113 where details of the two bonds that constitute this 'AT-1' are given;
4. The balance of 'Retained earnings' of £1.1bn (the £4.9bn in the first table less the £3.8bn taken to be part of Common Equity Tier 1) is taken to form part of 'Tier 2 capital';
5. The balance of 'Tier 2 capital' of £1.9bn (£3.0bn less the £1.1bn that is 'Retained Earnings') is constituted by part of the 'Other reserves';
6. 'Other reserves' of £7.7bn less the portion of £1.9bn qualifying as 'Tier 2 capital' is not recognised as capital at all, and is the 'Non-qualifying amount' of £5.8bn in the second table.

HSBC UK Bank plc's regulatory capital

Now we have the qualifying capital of HSBC UK Bank plc and its capital ratios, also given on p. 51, we need to insert one further step to avoid confusion, because the capital amounts on p. 51 are cumulative:

Capital Type		Amount
Common Equity Tier 1	A	£12.8bn
Additional Tier 1 capital	B	£2.2bn
Total Tier 1 capital	A+B	£15.0bn
Tier 2 capital	C	£3.0bn
Total, or 'regulatory', capital	A+B+C	£18.0bn

HSBC UK Bank plc's regulatory capital ratios

Capital Type	Numerator	Denominator	Ratio
Common Equity Tier 1 ratio	£12.8bn	£83.7bn	15.3%
Tier 1 capital ratio	£15.0bn	£83.7bn	18.0%
Total capital ratio	£18.0bn	£83.7bn	21.6%

The 'common denominator' - 'Risk-Weighted Assets'

The key issue is the denominator, which we have not addressed until now. It is the bank's 'Risk-Weighted Assets' or RWAs. This denominator is common to all of the ratios and is a critical element in understanding the strength of banks.

RWAs derive from every piece of the bank's risk-bearing business being processed through a methodology to determine what size of loss could result from it:

- Whether the business appears on the bank's balance sheet, like a loan;
- Whether it sits off the bank's balance sheet, like a guarantee, a trade letter of credit, foreign exchange contracts or derivatives;
- Including a large amount for operational risk: the loss that a major and systemically-important bank could sustain through IT failures, fraud and so on.

The result of the methodology's calculation is in all cases a given amount, which is the Risk-Weighted Asset equivalent of the piece of business concerned or, in the case of operational risk, the Risk-Weighted Asset equivalent of the risk-of-loss in the particular operational process.

All of these equivalents are then added up to determine the bank's total of Risk-Weighted Assets.

HSBC UK Bank plc 'Risk-Weighted Assets'

HSBC UK Bank plc has Risk-Weighted Assets of £83.7bn, which are broken out as follows on p. 51:

Risk category	RWA
Credit risk	£72.8bn
Counterparty credit risk	£0.1bn
Market risk	£0.2bn
Operational risk	£10.6bn
Total	£83.7bn

The key points are:

- The bank barely has any market risk because it holds no portfolio of securities and insignificant derivatives contracts, as these are the preserve of the non-ringfenced bank;
- The same applies to Counterparty credit risk: the bank has modest contracts in foreign exchange and derivatives, these also being the preserve of the non-ringfenced bank;
- Its cash balance at the Bank of England will not tie up significant capital because it ranks as a 'sovereign risk' asset and may have a 0% risk-weighting: its RWA equivalent could be zero;
- The bank's status triggers a substantial RWA for operational risk of £10.6bn;
- The major part of the bank's RWAs - £72.8bn – derive from credit risk.

How credit risk arises and how it crystallizes as the bank's RWAs

Credit risk arises in two main ways:
- From the £195.5bn of loans on the balance sheet;
- From the Contingent Liability contracts off the balance sheet shown on p. 113 of £70.4bn.

The majority of the Contingent Liability contracts are committed but undrawn loan facilities. Together with the drawn loans they add up to £265.9bn. That is their nominal amount.

The RWA equivalent of that £265.9bn is £72.8bn. The size of loss that the risk-weighting methodology estimates averages out to 27% of the nominal amount, or a 73% discount between the nominal amount and its RWA equivalent.

Pages 30-48 supply greater detail on the quality of the portfolio of business that contains credit risk. This data is meant to justify the risk-weighting. However much credence we give to that data, it is worth reflecting on what the bank's capital ratios would be without risk-weighting, based on the nominal amounts of the bank's loans and contingent liabilities:

Capital Type	Numerator	Denominator	Ratio without risk-weighting	Ratio with risk-weighting
Common Equity Tier 1 ratio	£12.8bn	£265.9bn	4.8%	15.3%
Tier 1 capital ratio	£15.0bn	£265.9bn	5.6%	18.0%
Total capital ratio	£18.0bn	£265.9bn	6.8%	21.6%

There is another balance sheet position that will currently be attracting a very low risk-weighting and possibly a 0% one: the £112bn balance at the Bank of England. Without risk-weighting at all, the denominator in HSBC UK Bank plc's capital ratios would swell to £377.9bn, more than its balance sheet footings on account of the Contingent Liabilities. Then the bank's capital ratios would be:

Capital Type	Numerator	Denominator	Ratio without risk-weighting	Ratio with risk-weighting
Common Equity Tier 1 ratio	£12.8bn	£377.9bn	3.4%	15.3%
Tier 1 capital ratio	£15.0bn	£377.9bn	4.0%	18.0%
Total capital ratio	£18.0bn	£377.9bn	4.8%	21.6%

Risk-weighting is core to the contention that banks are well-capitalized; without it, they aren't.

Incorporation of the high-risk SVB UK loan book into this situation

The impact of incorporating the high-risk SVB UK loan book into this portfolio is that it will add £5bn to 'Loans' on the balance sheet and eliminate £5bn of the cash balance at the Bank of England.

This is based on the assumption that very little of SVB UK's deposit book will remain after a period of 30-60 days: having been worried once that they might lose all their money bar £85,000, depositors will diversify.

SVB UK's loan book becomes funded by HSBC UK Bank plc's existing base of deposits, put there by UK consumers and businesses.

HSBC UK Bank plc thereby eliminates one asset with a 0% risk-weighting (Bank of England) and replaces it with another asset that would be risk-weighted at:

- 27% if it is risk-weighted at exactly the average risk-weighting of HSBC UK Bank plc's existing portfolio;
- Higher if it is higher-risk, BUT with the risk-weighting methodologies of SVB UK and HSBC UK Bank plc being identical – the RWA would be the same in both banks;
- Higher still if it turns out that SVB UK's risk-weighting methodology for the same piece of business delivered a lower RWA than HSBC UK Bank plc's methodology does;
- Much higher if due account is taken of the lack of the customary sources of repayment of loans to tech and fintech companies: the next VC funding round or an Initial Public Offering.

What is the quality of the SVB UK loan book?

Given that the existing loan portfolio of HSBC UK Bank plc is diverse, domestic, and based on funding UK consumers and businesses, and SVB UK's loan portfolio is concentrated on start-up and early stages enterprises, in the tech, biotech and fintech sectors, it would stretch credibility if the average Risk-Weighting was equal to or lower than 27% under the methodology of HSBC UK Bank plc.

However it is not beyond the bounds of possibility that it was at this level under SVB UK's methodology. SVB was not a systemically-important bank either in the USA or the UK and so its risk-weighting methodology was not as heavily scrutinized by financial regulators as is that of HSBC, which is classified as a Global Systemically-Important Financial Institutions (a GSIFI).

Banks tend to create methodologies that reinforce their own wishes rather than defend against them. In this case SVB's dedication to the sector and its conviction that it had greater insight into it than others will have convinced it that its credit assessment capabilities were better than those of the general banking market regarding its target markets, and that its superior insight and successful track record meant that its portfolio was on average of lower risk.

In other words SVB would have, over time, tilted its risk-weighting methodology towards showing that its business was of lower risk than the same business would appear to be if subjected to the risk-weighting methodologies of other banks.

Not being a GSIFI, its methodology would not have been scrutinized against global peers. In fact SVB would say that it had no global or even domestic peers. That would permit it to self-certify its methodology.

Risk-weighting of SVB UK's loan portfolio and the credit risk it contains

We can posit that the average risk-weighting of SVB UK's loan portfolio is considerably lower than the risk-weighting that would emanate from HSBC UK Bank plc's methodology.

Even this statement overlooks an important point: as SVB had no peer group, its loan portfolio will be alien to HSBC. Indeed its manner of assessing the risk of loss may turn out to be incompatible with the one within HSBC UK Bank plc.

But HSBC UK Bank plc **must** bring the loans within its methodology: it cannot treat SVB UK on an arm's-length basis and accept SVB's risk-weighting methodology as a given.

One has to ask, in the light of SVB's demise as a group, what the financial outlook is for its customer base. SVB's demise in the USA was caused by their customers not receiving new VC funding or doing Initial Public Offerings (IPOs), meaning they started to run down their cash balances earlier than SVB anticipated, which in turn exposed as fatal SVB's treasury decision to invest customer deposits in longer-term bonds.

The sector is not in good shape. It is not self-sustaining based on its sales, cashflow and profits. It requires regular cash infusions. VC funding has dried up for a reason. IPO is no longer an exit option for many firms, and, even if the IPO route is open, there is no guarantee that the money raised by an IPO will leave the firm able to meet all of its liabilities when they fall due. The outlook is bleak.

What is the correct risk-weighting of SVB UK's loans if they contain a high risk of loss?

The SVB UK loan portfolio contains a high risk of loss. This does not mean that it should be risk-weighted at 100%, though. It should be risk-weighted far higher. This is a common misconception amongst bankers, that 100% is the highest possible risk-weighting.

To illustrate the point, one must examine the most extreme case, which is where a total loss of the loan amount is a certainty, for example if a customer has gone into liquidation, the bank has no security, and there are other creditors with security whose claims greatly exceed the value of the asset pool as identified by the trustee-in-bankruptcy.

In that case, to mirror the certainty of a loss of the entire loan, the amount of Common Equity Tier 1 capital that should be held against the loan is the nominal amount of the loan, not a fraction of it. This is the accounting alternative to making a Loan Loss Provision in the nominal amount of the loan, or to writing down the value of the loan to zero: both of those approaches create a simultaneous diminution of capital in a like amount.

HSBC is a Level 3 GSIFI and this means that it must have a Common Equity Tier 1 Ratio 2% higher than the global minimum of 7%: it must have Common Equity Tier 1 in an amount of 9% of its Risk-Weighted Assets. If the risk-weighting of an asset were 100% - i.e. its risk-weighted value is the same as its nominal value – HSBC would need to hold only 9% of the nominal value of the asset as Common Equity Tier 1.

In order that HSBC should hold the entire nominal amount of an asset (in this case a loan facing a total write-off) as Common Equity Tier 1, the risk-weighting must be 1,111.11%. Then a loan of £100 converts into a Risk-Weighted Asset of £1,111.11, against which HSBC would have to hold 9% as Common Equity Tier 1 = £100.

Can we posit what the Risk-Weighting of SVB UK's loan book should be?

Given the problems in the sector, SVB UK's loan book should be accorded a risk-weighting in the region of 400% i.e. a loan book of £5bn nominal value becomes a Risk-Weighted Asset of £20bn, against which HSBC's minimum amount of Common Equity Tier 1 is 9%, or £1.8bn .

Such a Risk-Weighted Asset is 27% of HSBC UK Bank plc's entire Risk-Weighted Asset of £72.8bn for credit risk now. £1.8bn is 14% of the bank's Common Equity Tier 1 now.

Impact on HSBC UK Bank plc's Risk-Weighted Assets and capital ratios

In that case HSBC UK Bank plc's Risk-Weighted Assets would rise as follows:

Risk category	Old RWA	New RWA
Credit risk	£72.8bn	£92.8bn
Counterparty credit risk	£0.1bn	£0.1bn
Market risk	£0.2bn	£0.2bn
Operational risk	£10.6bn	£10.6bn
Total	£83.7bn	£103.7bn

The bank's capital ratios would decline as follows:

Capital Type	Numerator	Denominator	New ratio	Ratio now
Common Equity Tier 1 ratio	£12.8bn	£103.7bn	12.3%	15.3%
Tier 1 capital ratio	£15.0bn	£103.7bn	14.5%	18.0%
Total capital ratio	£18.0bn	£103.7bn	17.4%	21.6%

A decline in the bank's capital ratios means:

- The risk of failure has risen;
- The deposits are less secure;
- A call on the Financial Services Compensation Scheme is more likely.

Breach of principles weighed against actual degree of risk

These statements are indisputable as principles but say little about the increased degree of risk. The capital ratios still show a comfortable surplus over regulatory thresholds, albeit that those thresholds are all expressed as percentages of Risk-Weighted Assets.

It all comes down to the correctness of the risk-weighting.

The key point-of-principle is that ringfencing has been relaxed: ringfenced deposits will now fund loans that belong outside the ringfence, and the safety of the deposits depends on HSBC's risk-weighting methodology.

HSBC, on the face of it, looks as if it has ample liquidity in the form of its balances of £112bn with the Bank of England, and that it could afford to convert a large slice of that liquidity into customer loans without the bank becoming illiquid.

That much is true, but this positive picture depends largely on:

- Whether HSBC's risk-weighting of its existing loan book turns out to be correct;
- Whether new customer loans do or should convert into larger Risk-Weighted Assets.

Sensitivity of HSBC UK Bank plc to taking on bad business and possible responses

HSBC's capital ratios are very sensitive to bad lending: the addition of a book of only £5bn in nominal value, if risk-weighted at 400%, causes its capital ratios to fall by 3-4% (e.g. from 15.3% to 12.3%) and by 20% of their own value (e.g. a 3% fall is 1/5th of the original 15.3%).

If we take it as read that SVB UK's loan book does consume more of HSBC UK Bank plc's capital than its current average loan, and HSBC decided nevertheless that it had to maintain its capital ratios at the current levels, HSBC has a range of options:

- Not to renew loans to existing borrowers at their scheduled maturity dates;
- To reduce the headroom for new loans to be made to other customers;
- To increase lending margins on existing and new loans so as to strengthen the bank's loss cushion;
- To reduce rates paid on deposits owned by other customers.

Substance of HSBC's possible responses and outcome

These responses would amount to making less credit available to the types of customer and for the types of purpose that a ringfenced bank exists for and/or making UK consumers and businesses shoulder a higher cost (as more loan interest paid or as less deposit interest received) so as to enable HSBC's rescue of SVB UK.

The outcome is undeniable:

- Either HSBC UK Bank plc becomes less creditworthy; or
- It retains its creditworthiness by squeezing the amount of credit available to other customers, and/or taking more interest margin out of existing customers.

The first outcome exposes HSBC UK Bank plc's customers – who are taxpayers, as UK consumers and businesses – to greater risk in the first instance, and exposes all UK taxpayers to greater risk of sharing a loss through the mechanism of the Financial Services Compensation Scheme.[13]

The second outcome penalizes HSBC UK Bank plc's customers with higher costs and/or lower returns.

The rescue of SVB UK did require taxpayer support. The first line of taxpayer support is from the subset of taxpayers who are customers of HSBC UK Bank plc.

The second line of taxpayer support is through the Financial Services Compensation Scheme, and the risk of that support being needed has been raised by SVB UK's high-risk loan book being placed into HSBC's ringfenced bank.

BL/21.3.23

[13] The Financial Services Compensation Scheme is unfunded: in order to pay out to eligible depositors the scheme would have to receive the money from HM Treasury, who would have to issue more government debt to raise the money, for which debt all UK taxpayers are responsible.