EBA/CP/2013/02

EBA consults on the conditions for assessing the materiality of extensions and changes of internal approaches for credit, market and operational risk – HSBC response

Prepared by: Global Risk Strategy, HSBC Holdings plc

Date: April 2013

HIGHLY RESTRICTED

HSBC

Contents

Responding to this Consultation

1. Executive Summary

1.1. General Overview

We welcome the opportunity to comment on the draft EBA consultation paper EBA/CP/2013/02 on the conditions for assessing the materiality of extensions and changes of internal approaches when calculating own funds requirements for credit, market and operational risk under articles

We have responded specifically to each question in the paper below, but summarise two key areas of concern which impact the overall process.

In general the additional qualitative requirements (as detail in response to Q3) appear to raise the obligation to submit an increased number of notification requests where minor changes in RWA are seen. These would have usually been covered by regular close and continuous meetings with regulators who themselves are not necessarily resourced to undertake and increased level of processing that the additional requirements proposed in this consultation would entail.

For market risk, we consider the proposed standards overly onerous. For example, the look back period (i.e. 60 days) is too long and should be dependent on the nature of the change. In some cases a single day may be sufficient to demonstrate materiality content with 5-10 days of calculations regarded as a precedent. It is suggested that an appropriate standard is set up which does not inhibit best practise modelling/risk management.

2. Overview of questions for Consultation

2.1. Question 1

Are the provisions included in this draft RTS that specify the principles of categorisation of extensions and changes, sufficiently clear? Are there aspects which need to be elaborated further?

Q1: Response

No, additional clarity required on whether there are any additional options for exclusion from the pre- or post-notification process i.e. De-minimis list or annual calibrations whereby latest observations are included requiring change in the length and composition of time series for parameter estimation.

P.13 Title I, Article 2 points 5 and 6

What is the process of notifying competent authorities in such a scenario? Will it be the same process as for model notification?

P.14 Title II, Article 4 point 1(a)(iii)

This criterion seems redundant given the provision of 1(a)(iv). In would appear that if a notification is triggered by criterion 1(a)(iv), it will always imply that criterion 1(a)(iii) will be triggered also.

P.14 Title II, Article 4 point 1(b)

Potentially, this could mean an institution can implement a model change in January and won't notify the competent authority until December of that year. Is that acceptable?

Does this mean that we need to post-notify all changes only once a year or does this mean that we have 12 months to post-notify each change after its implementation?

P.21 Part II, Title I, (4)

Does validation methodology/process refer to pre or post model implementation validation? The validation methodology/process is often governed by a monitoring standards document. Does this proposal mean that changes to internal monitoring standards document should undergo a material notification process?

In general, more clarity can be achieved from the document by the use of examples

PROPOSAL: Suggest an example is provided in the form of an additional annexe which supports the proposals in this paper for the various Articles 1 – 9 to help support consistency of approach and interpretation.

2.2. Question 2

Are the provisions included in this draft RTS on the calculation of the quantitative threshold for the IRB approach sufficiently clear? Are there aspects which need to be elaborated further?

Q2: Response

P.13 Title II, Article 3 (2)

Where a model change takes place in a member state where the Holdings plc and its European subsidiary are both registered within the same member state, please clarify whether it is the Holdings plc or its European subsidiary that should be adopted as the EU parent institution equivalent for the calculation of the quantitative threshold? Under CRR Article 4 (65), the EU parent institution would be recognised as the Holdings plc. Please confirm.

(65) 'EU parent institution' means a parent institution in a Member State which is not a subsidiary of another institution authorised in any Member State, or of a financial holding company or mixed financial holding company set up in any Member State;

P.14 Title II, Article 4 (2)

Where a model change takes place in a member state where the Holdings plc and its European subsidiary are both registered within the same member state, please clarify whether it is the Holdings plc or its European subsidiary that should be adopted as the consolidated level of a parent institution which is not an EU parent institution or at the subsidiary level?

2.3. Question 3

Do you support the calculation proposal of the quantitative threshold for the IRB approach in terms of design of the metrics and level of thresholds? (Please also take into account the arguments provided in Tables 2 to 5 of the Impact Assessment).

Q3: Response

In general we support the calculation proposal of the quantitative threshold (subject to the clarification in Question 2) and to the use of both quantitative thresholds and qualitative criteria to assess materiality of extensions and changes to internal approaches. However, the current proposals would mean that changes described by the qualitative criteria, no matter how small the impact to RWAs, would need to be pre-notified. It is anticipated that the proposals will result in many more pre-notifications being made by institutions. Qualitative thresholds are also subjective and may bring inconsistencies. As such, it would be helpful to have a more detailed description of any qualitative thresholds used.

The calculation only looks at the total RWA movements in the models and does not look at individual changes in parameters where there may be offsetting of impacts.

2.4. Question 4

Do you support for the IRB approach the three month period for notification of the changes before implementation?

Q4: Response

Given the increased number of pre-notifications anticipated, timely response by the relevant competent authority would be critical for institutions to plan implementation time frames

PROPOSAL: Competent authorities should be held to service level standards in responding to model extension notifications and applications.

For process and data type changes, a 3 month timeframe for notification of the changes before implementation may not be practical since for these types of changes, there is often a pressing need for the change, e.g. replacement of personnel due to attrition, or fixing of a data quality issue.

PROPOSAL: Changes relating to process and data should either be post-notified or notified to the competent authority via regular close and continuous meetings.

It is our understanding that for this type of ex ante notification requiring a 3 month notice period, institutions are not required to seek approval from the competent authority before implementation, but merely to provide 3 month notice. Please clarify.

2.5. Question 5

Are the provisions included in this draft RTS on the calculation of the quantitative threshold for the AMA sufficiently clear? Are there aspects which need to be elaborated further?

Q5: Response

The quantitative criteria appear clear however there is a long list of qualitative criteria that either requires approval or ex ante notification. Given that a number of these criteria may potentially be interpreted differently and that a number apply to the wider Operational Risk management framework rather than purely the Operational risk model, it is hoped that a common sense approach is used by Regulators in applying these rules. Otherwise the process could become quite onerous for both Regulators and Banks.

2.6. Question 6

Do you support the calculation proposal of the quantitative thresholds for the AMA in terms of design of the metrics and level of thresholds? (Please also take into account the arguments provided in Tables 2 to 5 of the Impact Assessment).

Q6: Response

Please see answer to 1.5.1

2.7. Question 7

Do you support for the AMA the three month period for notification of the changes before implementation?

Q7: Response

Please see answer to 1.5.1

2.8. Question 8

Do you support that for the AMA no quantitative differentiation between changes requiring notification prior vs. post implementation is made?

Q8: Response

Please see answer to 1.5.1

2.9. Question 9

Are the provisions included in this draft RTS on the calculation of the quantitative threshold for the IMA sufficiently clear? Are there aspects which need to be elaborated further?

Q9: Response

Pre-/post- notification criteria, despite the efforts of the paper will be difficult to enforce and inevitably subjectivity will be required.

Question 10

Do you support the calculation proposal of the quantitative thresholds for the IMA in terms of design of the metrics and level of thresholds? (Please also take into account the arguments provided in Tables 2 to 5 of the Impact Assessment).

Q10: Response

No. The quantitative thresholds are a very theoretical approach to determine the capital impact due to a change in model. Noting that 60 days' worth of VaR numbers are required to determine a capital number, and then a further 6 months parallel run is required, this would lead to an effective 6 month worth of analysis just to determine whether a change is material or not. Not only is this an extraordinary length of time which would have severe implications on a model's development cycle, materiality assessment should not in itself be seen as a key objective. Rather, the assessment should rather focus on whether the change is conceptually sound. For example if Bank A has a poor model implementation, acknowledged by bank and regulator alike, then any improvement clearly would have an impact. To have to spend 6 months to determine how material the change is seems to miss the point of the exercise.

Furthermore, markets can evolve rapidly, as experience in the Eurozone demonstrates. We are required by regulators to ensure that all material risks are captured and that our back testing is preformat. In doing so, the risk models need to evolve. If the development cycle is impeded as proposed by the RTS, then the capital measure will continually be out of sync with the risk model and we are likely to see greater back testing exceptions.

Question 11

Do you support for the IMA the one month period for notification of the changes before implementation?

Q11: Response

On top of the onerous assessment this further delays development of the model. Whilst it is reasonable for the regulators to have sufficient notice of any change, the nature of the engagement should not be codified.

Also, the request is unbalanced and does not give any indication of how long regulators are permitted to take when forming a response.

Question 12

Do you support for the IMA the 60-day observation period for the purpose of comparing the modelling result before and after a proposed change?

Q12: Response

No

Question 13

Do you support that for the IMA for those modelling approaches which are only required to be calculated once a week (stressed VaR, IRC, CRM) to compare only twelve numbers for Article 7 paragraph 1(c)(iii)?

Q13: Response

Agreed there should be equivalent standards across the risk metrics but disagree with the length of observation period.

Question 14

Do you support that for the IMA no quantitative differentiation between changes requiring notification prior vs. post implementation is made?

Q14: Response

No. The governance standards need to better reflect the nature of the change.

Question 15

Are the provisions included in this draft RTS on the documentation requirements sufficiently clear? Are there aspects which need to be elaborated further?

Q15: Response

Yes but to ensure consistency of submissions from various institutions, suggest the inclusion of a template.

PROPOSAL: Suggest a template could be provided to enable consistency of format and approach i.e. similar to what was provided as an Appendix C from the PRA.

- It should be clarified on what level of documentation should be submitted as part of the “past version of internal models”.
- It should be clarified on how much details would be required on the “details of all extensions and changes planned for the internal approach over the next 12 months”. In most cases we do not have certainty on the direction of impact (i.e. decrease or increase in RWA) of planned changes.
- What is the difference between extensions and changes classified as “requiring competent authorities’ approval” and “requiring notification before implementation”? Which items can be implemented after notification but will not require approval?
- There is no mention of IMM models and believe their treatment should be made explicit.

2.10. Question 16

Do you support the view that costs arising for institutions from the documentation requirements included in the draft RTS are not expected to be material? If not, could you please indicate:

- the main cost driver: i) additional IT equipment, ii) additional ongoing Staff/hours, iii) other (please specify).
- the % increase in total yearly costs of internal models management for credit/operational/market risk induced by the proposed documentation requirements (specify whether the costs arise only for some of the risk categories covered by the provisions).
- indicative monetary amount of these additional costs (specifying currency and unit)

Q16: Response

Cost not expected to be material unless regulators globally undertake a non-equivalent approach in which case a doubling of effort to satisfy dual reporting (additional on-going staff/hours) as a minimum is not unrealistic

2.11. Question 17

Do you support the view that the additional costs, for institutions, of computing the quantitative impacts of the implemented model extensions/changes are expected to be non-material, given that institutions already carry out impact analysis in the current framework? If not please indicate:

- the main cost driver: i) additional IT equipment, ii) additional ongoing Staff/hours, iii) other (please specify).
- the implied % increase in total yearly costs of internal model management for credit/operational/market risk induced by the quantitative impact analysis (specify whether the costs arise only for some of the risk categories covered by the provisions).
- indicative monetary amount of these additional costs (specifying currency and unit).

Q17: Response

Cost not expected to be material unless regulators globally undertake a non-equivalent approach in which case a doubling of effort to satisfy dual reporting (additional on-going staff/hours) as a minimum is not unrealistic

PROPOSAL: align the figures used for RWA exposure amounts in the calculations to the financial institutions most recent quarterly reporting ie Q1, Q2, Q3 or Q4 as this simplifies the financial extract from underlying reporting systems?

2.12. Question 18

Do you support the view that, for institutions, the costs of ex-ante/ex-post notification of extensions/changes are expected to be non-material? If not, please indicate:

- the main cost driver: i) additional IT equipment, ii) additional ongoing Staff/hours, iii) other (please specify).
- the % increase in total yearly costs of internal models management for credit/operational/market risk induced by the notification requirements (specify whether the costs arise only for some of the risk categories covered by the provisions).
- an indicative monetary amount of these additional costs (specifying currency and unit).

Q18: Response

Cost not expected to be material unless regulators globally undertake a non-equivalent approach in which case a doubling of effort to satisfy dual reporting (additional on-going staff/hours) as a minimum is not unrealistic