Annex A - Answers to Questions

Section	Question	HSBC Response
4.3 - Overall Timeline & Prioritisation	1. The proposed prioritisation of regulatory products is based on the grouping of such elements that in the EBA's view can be implemented in a sequential manner. Do you agree with the proposed grouping? If not, what alternative grouping would you suggest?	While we welcome the EBA's initiative and positive attitude towards risk sensitivity and the recognition of the benefits of the IRB capital framework, we would encourage active and direct coordination with the Basel Committee, including clear, published alignment of timelines. This will help to avoid inconsistencies in the global capital framework and also the potential for duplication of effort - a key concern for banks already under a material burden of regulatory change. This is also of particular importance for banks which have a global, cross-border presence outside of the EU where the existence of differing capital frameworks across jurisdictions may lead to an 'uneven playing-field' and inconsistent requirements for local and consolidated capital reporting. The absence of coordination may further exacerbate RWA variance throughout the financial system. In terms of the proposed prioritisation, we would support the grouping and sequential manner as far as priority and materiality of topics, however given the interlinking nature of changes (e.g. definition of default with PD & LGD calibration), implementation should only be considered simultaneously. This is to avoid multiple iterations of the model development-validation-approval cycle on the same model.
	2. What would you consider the areas of priorities?	Prioritisation should be given firstly, and most importantly, to coordination at the Basel level. Inconsistencies and regulatory divergence across jurisdictions will further exacerbate the issue of RWA variance. As data sourcing and preparation is a precursor to model development, priority should be given to those initiatives which impact data sourcing and derivation. We agree that the Definition of Default is one of the fundamental building blocks in internal model development. Calibration of PD/LGD models would then logically be undertaken subsequent (given reliance on definition of default), but implemented simultaneously. Consideration should be given to assessing the impact of changes on real-life data to determine what the results would look like.
	3. Do you consider the proposed timeframe reasonable? In particular do you consider reasonable the proposed timeline for the implementation of the changes in the area of: a. definition of default; b. LGD and conversion factor estimation; c. PD estimation; d. treatment of defaulted assets; e. CRM?	We believe the timelines to be unrealistic and overly ambitious, particularly for the proposed changes to Definition of Default, and the subsequent calibration changes for PD, LGD and CF estimates. In addition to the time-consuming burden of reconstructing historic data, the resource intensive processes for model recalibration, validation, and internal approvals will be more evident in larger, complex firms with large numbers of credit risk models. Furthermore, the estimated increase in volume of model approval submissions - as required by the EBA RTS on changes to IRB models - will require sufficient time for competent authorities to complete. Without compromise on the data history requirements, we would envisage a 5-7 year phased rollout. Coordination should also be sought with all competent authorities to agree a plan and schedule to meet the approval requirements. In practice, the approval schedule and implementation will need to be agreed with supervisors on a bilateral basis. We would also be supportive of a phased implementation timeline which gives priority to the most material models, followed by sequential implementation of remaining models.
4.3.1 - Definition of Default	4. Are there any other aspects related with the application of the definition of default that should be	We believe the EBA has covered most aspects related to Definition of Default in the proposed RTS and Guidelines. We would still insist that the important role that expert judgement plays is not compromised by the guidelines. This is

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	clarified in the GL?	particularly relevant in the non-retail portfolios where specific knowledge of the portfolio, internal risk management, and economic realities remain key contributors to sound risk management practices.
	5. Do you have experience with adjustments of historical data? What are the methods that you used to adjust historical data, including both internal and external data?	There is limited experience with adjusting historical data, and only in some smaller retail portfolios. There has been no experience for non-retail portfolios, and not to the broad extent that would be required for all models. There are significant difficulties in reconstructing data: • The technical difficulties when certain new data attributes may not have previously been recorded/saved • Un-archiving, cleansing, and preparing data is resource intensive and requires IT system updates • Data quality may be compromised as the effects of active risk management and recovery practices that would have taken place could not be simulated The challenge will be to find the balance between the length of the historical data period and the reliability of that data. Adjusting data over lengthy periods may result in bias which will not improve comparability objectives. Without compromise on the data history requirements, we would envisage a 5-7 year phased rollout approach which would allow for the effect of risk management practices to be reflected and data capture implemented.
	6. To what extent is it possible to adjust your historical data to the proposed concept of materiality threshold for the purpose of calibration of risk estimates?	We do not think the adjustment of historical data is either practical or feasible, given the significant burdens of IT development, data collection, and the inability to capture business processes / risk management practices which would have had a significant effect on distressed or defaulted customers under the new requirements. Rather consideration could be given to a forward-looking phased rollout. Specifically on LGD models, a change in the definition of default will change the timing of default, and therefore the cashflows collected data. Attempting to restate this historical data may not be possible where that additional cashflow information is not available.
4.3.2 - Risk Estimates	7. What is the expected materiality of the changes in your IRB models that will result from the proposed clarifications as described in section 4.3.2?	The materiality will depend on the final RTS, guidelines and proposals from the EBA, however at this time there is insufficient detail in the discussion paper to provide a detailed assessment. We would however note that the PD and LGD estimation proposals will introduce material changes as it relates to margins of conservatism, downturn and stress specifications. Furthermore, in respect of the Commission Delegated Regulation (EU) 529/2014 on the materiality of changes, the proposals constitute a 'material' change to models (definition of default) which require approval by the relevant competent authority. As detailed in the answer to Question 3, coordination will need to be sought with supervisors on meeting this requirement.
	8. Do you consider the direction of the proposed changes adequate to address the weaknesses and divergences in the models across institutions?	Yes, we support the direction of the proposed changes and believe that it continues the work already underway to reduce divergences and address identified weaknesses. Indeed we would draw attention to analysis already undertaken in the industry and representative bodies (e.g. the AFME paper on downturn LGD in Feb 2015). These help to identify areas and cause of variation and divergence which should be addressed by proposals. We would also caution that replacement of LGD estimates with supervisory floors would misrepresent risk and incentivise unintended behaviours (e.g. seeking higher returns on transactions with lower recovery rates, or disguising the benefits/risks of secured vs unsecured lending).. In relation to the treatment of multiple defaults, we agree that multiple defaults may impact both PD and LGD. However, we note that the variance in the treatment of multiple defaults stems from the different definitions of multiple defaults, and the practice of grouping multiple defaults into a single default to be harmonized. Nevertheless, we do not believe the issue of multiple defaults is a material driver of RWA variance, and that banks do not immediately put exposures back in non-defaulted status and multiple defaults within one year are rare. While harmonisation is welcomed as a method to improve comparability we would caution that it does not detract from, or become an obstruction to risk sensitivity and internal risk management practices.
	9. Are there any other aspects related with the estimation of risk parameters that should be clarified	We would support further guidance and harmonisation particularly on the topic of Low Default Portfolios as they often represent clients that play an important role in the provision of credit and growth for the economy. In particular:

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	in the EBA guidelines?	• An EU-consistent definition of LDPs • How to address data gaps/issues for LDPs • Focus on external data, and also encourage and incentivise cross-firm data pooling
4.3.3 - Treatment of Defaulted Assets	10. Do you have dedicated LGD models for exposures in default that fulfil the requirements specified in section 4.3.3.(ii)?	Historically, there have not been dedicated LGD-in-default models, rather it is implicit in the LGD models themselves which are based on historic loss experience, including downturn and margins of conservatism. The aim would be to actively work towards a consistent target approach (across jurisdictions and products/assets) in line with the DP, however noting that longer timelines would be required to support further model development and changes. For the benefit of comparability (and simplicity), we believe the EBA should propose more precise guidance on 'LGD in default' to ensure consistency in bank practices. The EBA should also consider how this particular topic links with the provisioning requirements of IFRS9 when further developing these proposals.
	11. Do you consider the direction of the proposed changes adequate to address the weaknesses and divergences in the treatment of defaulted assets across institutions?	We are supportive of the proposals and the direction they are heading to provide more consistency and clarity on the treatment of defaulted assets. We also agree that more specific guidance would clarify the conceptual basis of both the LGD and ELBE metrics, and also improve the level playing field. We would need to understand how strictly the guideline would be enforced as well as the timelines, and given the lack of consistency in the industry an appropriate implementation period would be required.
	12. What else should be covered by the GL on the treatment of defaulted assets?	We believe the proposed guidelines cover the relevant points, however consideration should be given to the implementation of IFRS9 and to avoid any potential conflicts. We would remain cautious should the final guidelines become more specific or granular. The EBA should also clarify para 69 and whether the scenario where there are no differences between ELBE and specific credit risk adjustments is acceptable.
4.3.4 -Scope of Application of IRB (PPU & Rollout)	13. What are the impacts for the institutions that should be considered when specifying the conditions for PPU and roll-out?	We would refer the EBA to the response to its consultation EBC-CP-2014-10 in September 2014. The proposed 8% threshold is restrictive and unwarranted, and lacking a clear mandate from the provisions of the CRR. The proposed conditions need to take account of, but not limited to: • Presence in emerging markets where modelling of exposures are difficult to achieve • Proportional consolidation of associates where insufficient granular detail and control is available to model exposures under IRB • Potential for inequitable distributions of exposures across asset classes where threshold proposals are set at that more granular level Further consideration should be given to the types of portfolios that can be modelled to the applicable regulatory requirements, and whether competent authorities have appetite to approve models for those portfolios. The consequence of strictly enforced rollout plans and restrictive thresholds will be to drive efforts to develop models to only meet those rollout targets rather than the fundamental aim of strong risk management and measurement.
4.3.5 - Internal Risk Management Processes	14. Do you expect that your organisational structure and/or allocation of responsibilities will have to be changed as a result of the rules described in section 4.3.5?	The proposed changes will impact differently across organisations, dependent on the structures in place. We think the proposals to completely separate model validation and model development functions are unnecessary where 2nd and 3rd lines of defence are already provided by internal model review and internal audit functions. Discretion should be granted to competent authorities to ensure adequate governance and independent oversight is in place for models.
4.3.6 - Credit Risk Mitigation	15. Do you agree that CRM is a low priority area as regards the regulatory developments?	We agree that the specific proposals for CRM as described in the DP are of lower priority. Nevertheless, we believe the CRM framework to be very important and warrants careful consideration of enhancements to the scope and eligibility of

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		credit risk mitigants recognised under the Foundation approach. This should be closely coordinated with the BCBS.
4.3.7 - Conclusions	16. Are there any other significant intra-EU or global discrepancies?	In terms of the global 'level playing field", there are 2 issues which stand out: • No absolute or relative threshold for definition of default is set by supervisors in certain other regions, but can be set internally (and reviewed by supervisors) • The provision available in the CRR to apply a 0% risk weight to EEA Sovereign exposures remains an exception to other global regulatory provisions Within the EU, there is potential disagreement regarding the definition of default for retail products. The UK PRA favours a facility-level default definition, whereas the French Prudential Supervisory Authority has historically favoured an obligor-level approach.
4.4.2 - Transparency & Supervisory Reporting	17. Do you agree that the area of disclosures needs to be strengthened, in particular with regard to disclosures related with the benchmarking exercise, for instance by publishing them on the EBA website?	We support transparency as an aid to external parties to understand institutions and internal models, and that disclosure is a fundamental avenue to achieve this. We also understand that transparency and disclosure are beneficial to the credibility of internal models. However we would caution that the extent of information disclosed needs to be accurate, and most importantly understandable and not lead to divulging sensitive internal information. As explained in the response to the EBA's RTS on benchmarking, we believe there are a number of flaws and issues which need careful interpretation (this can only be achieved in consultation with an NCA). Indeed benchmarking and HPE exercises can never fully reflect real bank portfolios and concentrations - the differences in credit approval procedures and distinct local markets compromises comparability. These exercises are also subject to operational risk when not processed through the established normal procedures and controls framework, but performed in spreadsheets. Furthermore, while risk sensitivity remains a shared objective, there will always be a justifiable level of variance. Subjecting benchmarking results to public scrutiny could incentivise banks to strive for the mean and be counter-productive; results clustered closely to an industry average will amplify the focus on outlier banks and possibly penalise them unfairly. We do not think that the proposals to increase disclosure through publication of these benchmarking, HPE, or other similar exercises would be helpful. In fact we would strongly argue against this in the absence of a robust process to ensure any potential 'noise' is explained and removed from the results. There have been numerous enhancements to the Pillar 3 disclosure in recent years, along with the publication of other stress testing and capital adequacy exercises. Institutions have established governance arrangements for the disclosure of information and we would recommend that the existing framework of Pillar 3 be utilised for that purpose.
	18. Would you support EBA Guidelines targeted at disclosure requirements related with the IRB Approach and taking into consideration the proposals of the Basel Committee on those requirements? Which current disclosure requirements should be given the priority? What should be the timetable for such Guidelines?	While we support the EBA proposals to issue guidelines for harmonisation of ad hoc disclosure, this should be consistent with the BCBS disclosure requirements to ensure consistency and comparability across the global financial system.
	19. Would you like to see any modification of the reporting framework implemented in terms of IRB exposures?	We would support EBA proposals which align with the BCBS revision of Pillar 3 disclosures. The key principles being to disclose on normalised tables, layouts, and scope (asset classes). It is envisaged that this would allow great transparency and comparability between institutions.
4.5.1 - Low Default Portfolios	20. What would you consider an appropriate solution with regard to the definition and treatment (modelling restrictions) of the low default portfolios?	We would support further guidance and harmonisation particularly on the topic of Low Default Portfolios as they often represent clients that play an important role in the provision of credit and growth for the economy. In particular: • An EU-consistent definition of LDPs • How to address data gaps/issues for LDPs • Focus on external data, and also encourage and incentivise cross-firm data pooling

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4.5.2 - Permanent Partial Use	21. How would you ensure appropriate use of the IRB Approach in a harmonised manner without excessive concerns of the so called ‘cherry picking’?	We do not see this as an excessive concern where oversight is provided by the competent authority. There is regular provision/update of rollout plans and associated detail on portfolios not yet treated under IRB. This discretion should be provided to the competent authorities with the EBA to monitor at that level.
4.5.3 - Harmonisation of Exposure classes	22. Do you see merit in moving towards the harmonisation of the exposure classes for the purpose of the IRB and the Standardised Approach?	Yes, exposure classes should be harmonised between IRB and Standardised Approach.
4.5.4 - Philosophy of Ratings models	23. Would the requirement to use TTC approach in the rating systems lead to significant divergences with the internal risk management practices?	We do not support the mandatory use of TTC for internal risk management purposes as it would lead to significant divergences. In reality, the appropriateness of PiT or TTC for internal risk management will differ across firms based on their risk appetite, portfolio type, business model and structure. For example, a firm which originates assets to hold and one which originates assets to manage/hedge will take differing views on the preferred PD approach for risk management.
4.5.5 - Data Waiver	24. Do you agree that the possibility to grant permission for the data waiver should be removed from the CRR?	In view of the fact that Basel II introduced this requirement in January 2008, when the majority of institutions applied (and received) IRB permissions, this will have little effect on those established firms. However, the intent of this provision was originally to reduce the barriers to entry for new firms wanting to apply for an IRB permission, and the removal from the CRR could be considered as introducing this barrier again.
4.5.9 - Other Aspects of IRB	25. Are there any other aspects of the IRB Approach not discussed in this document that should be reviewed in order to enhance comparability of the risk estimates and capital requirements?	We believe the discussion paper covers the material issues which will address concerns over comparability and RWA variance.