Response to EBA/CP/2014/10

Draft RTS on sequential implementation of the IRB Approach and permanent partial use under the Standardised Approach

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HIGHLY RESTRICTED

1. Introduction

HSBC is one of the world's largest banking and financial services organisations. With more than 6,200 offices in both established and emerging markets, we aim to be where the growth is, connecting customers to opportunities, enabling businesses to thrive and economies to prosper, and ultimately, helping people to fulfil their hopes and realise their ambitions.

We serve around 52 million customers through our four Global Businesses: Retail Banking and Wealth Management, Commercial Banking, Global Banking and Markets, and Global Private Banking. Our network covers 74 countries and territories in Europe, Asia, the Middle East and North Africa, North America and Latin America.

Listed on the London, Hong Kong, New York, Paris and Bermuda stock exchanges, shares in HSBC Holdings plc are held by about 216,000 in 129 countries and territories.

2. Response

HSBC welcomes the opportunity to respond to the EBA's Consultation Paper EBA/CP/2014/10 "Draft RTS on the sequential implementation of the IRB Approach and permanent partial use under the Standardised Approach under Articles 148(6), 150(3) and 152(5) of Regulation (EU) No 575/2013 (Capital Requirements Regulation – CRR)".

Key Points

- HSBC currently undertakes proportional consolidation of our associates as per the PRA's application of Article 18 of the CRR. In this instance, where consolidation is required but where no controlling interest exists, a bank is not able to impose the choice of a particular approach upon the associate and even if an IRB approach was used, limitations exist in access to the underlying data and models.
- Furthermore, the fact that the local IRB models would not have been approved for use by the group consolidated regulator, would force the bank to calculate RWAs for those exposures applying a Standardised Approach. This is a situation not currently contemplated in Article 150 but that would need to be considered by the EBA when defining conditions of application for some of the points in that article and any related materiality threshold calculations. A solution to this would be to grant discretion to the competent authority over the inclusion of associates where proportional consolidation is required under the national application of Article 18, in the calculation of thresholds.
- The 8% threshold proposed in article 1(1) (a) and (b) of the draft RTS place an unwarranted and fixed restriction for institutions, adding an additional and unnecessary burden to the rating system process. There is also no clear provision in the CRR that provides a mandate to set such a threshold.
- The 8% threshold proposed in Article 3, if implemented, should be set at the level of at least 15% given the impact of the wider global influence on those institutions operating within emerging markets and countries where development of models is difficult to achieve.
- If thresholds are to be implemented, a more flexible cumulative level of, say 25%, covering (a) (b) & (c) would be more workable, with the institution delivering within this total, across all portfolios. This would then support a more reasonable minimum 75% IRB coverage.
- The quantitative thresholds should apply only at the consolidated level.
- Our preference is for threshold calculations to be based solely on RWAs not EAD or a combination of the two.
- Neither of the two proposals offered under Q3 provides a viable solution due to their impact and complexity.

2.1. Specific questions

Q1. Do you agree with the proposed draft RTS regarding the sequential application of the IRB Approach?

HSBC is in a position to comply with a 50% initial transition limit as proposed, and can agree with the proposed draft regarding sequential application of the IRB Approach subject to flexibility for the maintenance of increased levels of permanent exemption, where geographical impact and control of underlying asset ownership demand.

Q2. Do you agree with the proposed draft RTS regarding permanent partial use of the Standardised Approach (SA) for the exposures specified in Article 150(1) (a) and (b) of the CRR?

The inclusion of the three thresholds for Articles 150(1) (a) and (b) and additionally under Q3 for Article 150(1) (c), over complicate assessment arrangements and may prove inequitable where an institution has uneven distributions across exposure classes. Whilst an 8% threshold for (a) and (b) may be sufficient to allow compliance, it is observed that there is no clear provision in the CRR to mandate the setting of such a threshold.

Q3 Do you agree with the proposed draft RTS regarding permanent partial use of the SA for the exposures specified in Article 150(1) (c) of the CRR?

As referred to in Q2 the application of individual thresholds is not appropriate. The make-up of immaterial exposures and / or exposures in non-significant business units and those where no controlling interest is maintained, can be disparate in institutions engaged in business across a broad spectrum of international boundaries. If a single threshold is warranted, a minimum threshold of 15% would be more appropriate.

For increased flexibility, rather than fixed thresholds at 8% as currently specified across (a) (b) & (c), a cumulative threshold of say 25% would be more workable. This would provide an institution with the ability to allocate according to its respective risk profile be that a national, European or international organisation. Single thresholds would seem more appropriate for smaller national organisations operating in a limited environment.

Which of the two alternative proposals presented in the impact assessment section under ‘Technical options considered’ do you prefer?

Neither technical option offers a fully workable solution:

Proposal 1 - flexibility based on mandatory quantification by approximating IRB capital requirements.

Under this option competent authorities must perform a risk analysis of the portfolios under the Standardised Approach to identify whether the potential for underestimation of credit risk is still immaterial.

The approach requires the competent authority to calculate the IRB capital calculation for all exposures using proxies - external ratings, internal (non-approved) estimates, historic default rates and losses; third party vendor estimates and benchmarks based on other institutions.

- Such an approach is likely to be resource intensive for both the regulator and the institution;
- Many of the portfolios that an institution chooses to leave on a Standardised Approach are due to an absence of the proxy data cited above;
- Many customers have no external ratings. For example, small customers or countries with low ratings penetration. Even where external ratings are present, mapping from external grades to PD bands is not necessarily appropriate as it depends on the type of ratings available i.e. understanding what the rating provided by the rating agency means. Some rating agencies produce a pseudo EL rating rather than a PD style rating. This clearly blends PD and LGD characteristics, so even if a rating is available, the rating needs to be decomposed into two parts (by having an internal estimate of either parameter) to arrive at the other parameter. Also there is

a difference between issue rating i.e. a particular financial instrument and issuer rating. The former is peculiar to the instrument, the latter is more generic;

- There are many portfolios with few historic default and no losses and limited broader market data, either because of the nature of the portfolio or because there is no sharing of data;
- The use of other bank models might not be an option for the home regulator - e.g. where they are not the home/host regulator of another bank with a comparable portfolio and again you would need to ensure that the model was appropriate to the target portfolio;
- The use of a non-approved internal model (say one built for impairment calculation or pricing) would be a tacit approval of the model in question;

Proposal 2 - Relies on "perceived risk profile"

The approach under Proposal two is somewhat subjective.

- The first part seems to suggest that the threshold would be reduced where a firm is using Foundation IRB (rather than Advanced);
- The second seems to suggest that where a firm is using a PD/LGD approach to equity and specialised lending, rather than simply risk weights or slotting, this increases the exposures that the firm is allowed to retain on the Standardised Approach;
- The third part again assumes that for the residual Standardised exposures that the firm can calculate risk parameters broadly in line with IRB minimum requirements.

To address the first point, while the Advanced approach is more risk sensitive than Foundation, it does not necessarily follow that it is always more conservative. Namely, as there are differences in the mitigation that can be recognised under each approach, also as Foundation IRB parameters act as both a floor and a ceiling.

The second part fails to reflect that regulators may choose to disallow certain approaches. For instance the PRA will not allow a firm to use PD/LGD models for Income Producing Commercial Real Estate exposures. Also as regards to equity exposures, the immateriality of these and whether they are treated under IRB or Standardised, is considered under a separate exclusion and should not factor into this debate.

The third part again seems to require a firm to have models for all exposures using an approach broadly comparable to the IRB approach. This will not be the case and therefore inherits the weaknesses of Proposal 1.

In conclusion, Proposal 1 is preferred to 2 but neither is presently workable in the suggested form.

Q4: Do you agree with the quantitative thresholds proposed in Articles 2(1), 3 and 4(2) of these draft RTS?

HSBC currently undertakes proportional consolidation of our associates as per PRA's application of Article 18 of the CRR. In this instance, where consolidation is required but where no controlling interest exists, a bank is not able to impose the choice of a particular approach upon the associate. Even if an IRB approach was used, limitations exist in terms of access to the underlying data and models, as well as the fact that the local IRB models would not have been approved for use by the group consolidated regulator, would force the bank to calculate RWAs for those exposures by applying a Standardised Approach.

The above is a situation not currently contemplated in Article 150 but would need to be taken into account by the EBA when defining the conditions of application of some points in that article and any related materiality threshold calculations. A solution to this situation would be to grant discretion to the competent authority over the inclusion of associates where proportional consolidation is required under the national application of Article 18, in the calculation of thresholds.

Our recommendation is for threshold calculations to be based solely upon RWAs rather than EAD or a combination of both.

Fixed thresholds are not suitable in this context.

If not, what thresholds do you consider more suitable?

An internal assessment of risk within each exposure class is more appropriate with a cumulative threshold set by the competent authority that understands the structure and operational footprint of the institution.

Q5: Do you think that separate quantitative thresholds should apply for application of these draft RTS on an individual and on a consolidated basis?

Thresholds should be applied on a consolidated basis to provide flexibility for institutions operating in a global market where a spread of emerging markets and less advanced modelling development, would be penalised under separate thresholds.

Which of the two alternative proposals presented in the impact assessment section under 'Technical options considered' do you prefer?

Two options are presented

Option 1 - Apply identical quantitative thresholds on a consolidated basis and an individual basis for institutions that are not subject to consolidated own funds requirements, but separately defined thresholds on an individual basis for institutions that are subject to consolidated own funds requirements.

Option 2 - Individual quantitative thresholds for institutions that are subject to own funds requirements, defined in terms of the consolidated quantitative threshold (where applicable).

Option 1 is not clear. Our understanding is: 1) consolidated entities and stand-alone entities shall have the same quantitative threshold; 2) Institutions that are subject to consolidated supervision, shall on an individual basis, be able to have different quantitative thresholds. However, it is observed that the text below the options seems to suggest identical thresholds for all entities within a Group.

Option 2 seems to suggest that quantitative thresholds are set individually but where institutions are part of consolidated Groups, would be set in the context of the consolidated entity.

Based on how the two options are written, they would appear to be similar. However, we understand that the EBA believes that option 1 represents identical thresholds within a Group. As such, this would not be appropriate, as it takes no account of the size, complexity of any entities within a Group or allow for sequential roll out, should a firm wish to roll out to different entities in different timescales.

On the above basis, Option 2 appears to offer more flexibility but further clarity is required.

Q6. Do you agree with our analysis of the impact of the proposals in this Consultation Paper? If not, can you provide any evidence or data that would explain why you disagree or which might assist our analysis of the possible impact of the proposals?

Overall, we disagree with the EBA proposals, as they limit flexibility and seek to apply a 'one size fits all' approach which is not conducive to the more advanced assessment of risk being implemented across IRB institutions.

Responses to the above questions provide detail in respect of our concerns in respect of the consultation. This has also been submitted in the separate BBA response which reflects many of our concerns.