

European Banking Authority
One Canada Square (Floor 46)
Canary Wharf
London E14 5AA

7 May 2015

Confidential

EBA Discussion Paper on the Future of the IRB Approach

Dear Sir/Madam

HSBC welcomes the opportunity to respond to the European Banking Authority ('EBA') discussion paper on the Future of the IRB Approach.

HSBC is one of the world's largest banking and financial services organisations with assets of US\$2,634 billion at 31 December 2014, serving customers worldwide from over 6,100 offices in 73 countries and territories in numerous geographical regions: Europe, Asia, Middle East and North Africa, North America and Latin America. As an internationally active bank we are generally supportive of the EBA's aim of harmonising differences in the Internal Ratings Based (IRB) approach across the European Union, and are similarly supportive of initiatives that aim to promote global harmonisation.

Moreover, the EBA discussion paper has sent a strong signal to the international regulatory community that it is committed to internal models and risk sensitivity and, in this regard, will take action to uphold the integrity of the internal models framework. We applaud this stance and are pleased to contribute to efforts that will support the EBA's objectives.

HSBC has been an active participant in a number of trade association responses to the EBA discussion paper including: the Association Financial Markets Europe (AFME), the British Banker's Association (BBA) and the International Institute of Finance (IIF). We are fully supportive of the points and issues raised by the wider financial services industry within these various responses. This letter lays out a set of high-level policy objectives where we believe the EBA should focus its attention. More detailed comments relating to the specific discussion paper questions are included in an Annex.

I. Support for risk sensitivity and the IRB framework

HSBC supports the use of internal models which provide the basis for regulatory capital calculation for credit risk, market risk and operational risk. However, internal models not only drive RWA calculations, they are also an essential tool embedded in the risk

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management of a firm to support risk-adjusted pricing of customer transactions, strategic investment decisions and management information. In this regard we are supportive of the EBA's approach towards improving the IRB approach rather than abandoning it. It is however unclear that the wider regulatory community is supportive of the continued development and preservation of internal models. This introduces significant uncertainty for firms and may result in resources being diverted away from investment in internal models.

We would note that there is the risk that efforts devoted to harmonising risk parameters within the EU will be undermined by regulatory proposals that introduce rather more blunt risk insensitive measures such as capital floors, or the flooring of certain portfolio types—notably Low Default Portfolios (LDPs). There is an increasingly rich environment of data—whether in the form of external agency data or cross-firm data pooling initiatives—which can serve to enhance firms' risk management and internal modeling capability. While certain portfolios may indeed experience a low number of defaults that is not to say that they also suffer from low data availability. We would also like to draw attention to the fact that detailed models will be required for firms to implement IFRS 9. If models are removed for capital purposes, this would result in a disconnect between capital requirements and impairment calculations.

It would therefore be extremely helpful if other regulatory bodies and individual regulators—both within the EU and globally—were to echo the sentiments included in the EBA discussion paper, by voicing their support for re-calibrating internal models to reduce RWA variance and improve consistency. This would send a positive signal to financial institutions that regulators still see value in the IRB framework and are therefore committed to improving it.

II. Basel coordination

As a large internationally active bank in over 74 jurisdictions regulatory consistency is of paramount importance to HSBC. With this in mind, it is worth noting that because HSBC is headquartered in the European Union, all CRD IV requirements (including EBA Level 2 measures) will apply on a consolidated basis and therefore to all global operations, including those outside of Europe. As many of HSBC's portfolios are regulated by competent authorities in different global jurisdictions, there is a need for alignment across these competent authorities. Divergent regulation therefore weakens our ability to efficiently manage risk on a global basis. From a global perspective, we are of the view that the Basel Committee is the most appropriate body to guarantee regulatory consistency.

It has been noted within the EBA discussion paper that a number of the proposed IRB harmonisation initiatives coincide with areas where the Basel Committee is planning to introduce its own reforms. It is encouraging that the EBA has chosen to take a

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proactive stance on this important matter, and HSBC is happy to provide positive contributions on how greater consistency and harmonisation of IRB parameters might be achieved. We would nonetheless caution that reforms must be well coordinated and actively discussed with the Basel Committee prior to their implementation.

In this regard, we would encourage a formalised coordination initiative to be launched at the Basel Committee level to avoid undertaking reforms which require significant change to firms' operations, governance and infrastructure within the European Union only to be amended at a later stage when Basel reforms are introduced. This would also ensure that the international regulatory community is fully supportive and invested in any harmonisation of IRB risk parameters.

III. Implementation timing

In order to efficiently manage the heavy workload which will be required by the EBA's various Level 2 mandates, the EBA has very sensibly proposed a 'phased-in' approach for the development of its various forthcoming regulatory products. We are in broad agreement with the phases outlined and their sequencing in terms of prioritisation, but would note that those impacting model redevelopment and re-calibration should be implemented simultaneously to avoid multiple phases of model development.

- Phase 1: IRB assessment methodology
- Phase 2: Definition of Default
- Phase 3: LGD and conversion factor estimates, PD estimation and Treatment of defaulted assets
- Phase 4: Credit Risk Mitigation (CRM)

More generally, while HSBC is in agreement with the proposed 'phased-in' approach, we have significant concerns with the suggested overall timeline for implementation. We are of the view that each individual Phase is likely to take more time than is proposed in the discussion paper, and that as a result the collective timeline will need to be prolonged considerably. In particular, we note that under Phase 2 Definition of Default, work on the EBA RTS on materiality threshold of credit obligations past due and on Guidelines (GL) on the application of the Definition of Default, will introduce material changes which have the potential to entail significant burden for implementation.

Proposals that require the adjustment of historical data will be particularly challenging and time-consuming. Moreover, because any change to a firms' definition of default

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would be considered as material¹, all of its credit models will need to not only be re-calibrated but submitted to internal validation and review, as well as submitted for supervisory approval. With this in mind the proposed two and a half year implementation period seems extremely unrealistic.

With this in mind, we are supportive of the recommendations made within the AFME response to the EBA discussion paper, suggesting alternative approaches to alleviate the burden of historical data adjustments. More specifically, we would support allowing firms to use proxies for the completion of their historical data adjustments. We are of the view that this would be an efficient way of facilitating back-dating requirements.

We would submit that, without compromise on requirements to back-date historical data, firms will require at least seven years of data for appropriate model development and calibration. Submitting models to internal governance processes and supervisory approval will also require more time than usual due to the aggregate burden of re-calibrating all wholesale and retail credit models simultaneously. Additional time, beyond the time needed for model development and re-calibration, will be needed to complete internal governance and regulatory approval. Finally, because LGD and PD calibration will necessarily depend on changes made to the Definition of Default, Phase 3 will need to be prolonged accordingly.

HSBC has been pleased to respond to the EBA discussion paper on the Future of the IRB Approach. Should the EBA wish to discuss any of the points mentioned in our response in more detail we would be more than happy to do so.

Kind Regards,



Manoj Bhaskar
Global Head of Global Risk Analytics

¹ As per the EBA RTS on for assessing the materiality of extensions and changes of the Internal Ratings Based Approach and the Advanced Measurement Approach No 529/2014.

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