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Dear Sirs

**Proposals for consultation on the expanded criteria for material risk takers based on remuneration.**

We welcome the opportunity to respond to the Draft Regulatory Technical Standards on criteria to identify categories of staff whose professional activities have a material impact on an institution's risk profile. Our response has been jointly crafted by the HSBC Risk and Remuneration teams with the aim of providing feedback that considers both the risk profile of HSBC and the practical implications for reward operation.

Overall we believe that the criteria will provide a more robust and clear basis on which to identify material risk takers within HSBC. However, there are a number of areas which we feel would be more effective after clarification, or which may have practical consequences unintended by the drafters.

As highlighted in our responses below certain prescriptive criteria will have the effect of capturing a number of people who have no material impact on the risk profile of the Group. This is likely to exacerbate some of the undesirable consequences of the CRDIV requirements including:

- Increasing the cost base of European banks and increasing the cost of borrowing for consumers;
- Damage to the competitive positioning of European banks, especially in key markets outside of Europe;
- Reducing the opportunities for clawback, potentially creating a perverse increase in risk profile; and
- Creating a talent drain and asset migration to Non-European institutions.

We provide our responses below, drawing where appropriate on those specific questions set out in the consultation paper.

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## Article 3 (1) (a)-(e)

We believe that the focus of the criteria should fall primarily on those individuals who can influence and shape the risk profile of the Group and not necessarily the full hierarchy of individuals whose role is to carry out the Group's business on a day-to-day basis and within pre-approved internal limits and controls that are being monitored, and sanctioned if breached.

The EBA should instead empower banks to consider additional factors that have a direct and material relationship in dictating the strategy and the risk profile of an institution such as market externalities (e.g. interest rates), prospects of the relevant local economy and business sectors' growth.

## Article 3 (1) (d)

Due to the nature of the HSBC Group structure, the requirement to include all heads of separate legal entities will capture a number of individuals within HSBC whose professional activities or managerial responsibilities do not in relative terms have a significant impact on the risk profile of the firm. We suggest that this specification be removed or qualified to recognise the unintended impact on some firms, without undermining the purpose or spirit of the Article.

## Article 3 (1) (e)

### *Q1: Is the list of specific functions listed appropriate or should additional functions be added?*

This requirement brings greater clarity to the existing legislation on the nature of roles that are within the definition of Material Risk Takers. However, it may be appropriate to amend this provision to enhance flexibility in identifying those roles that should be covered within the "head of function" category. This will prevent the unintended consequence of including individuals with only a limited or notional influence over the named area, where a more senior role would be more appropriate. Listing the relevant roles within this section also risks the exclusion of other, more appropriate roles depending on the nature of a firm's structure and risk profile.

If additional risk categories are to be taken into consideration, some of the additional functions that need to be included are for example: the Chief Financial Officer, the Head of Operational Risk, as well as individuals on key committee structures for the determination of internal limits, such as the Chair of the Asset-Liability Committee (ALCO).

It should also be recognised that each firm's structure is different with certain roles having more significant exposure to risk than peers in other organisations. It may be appropriate to allow dispensation to those employees captured by the functional criteria if the firm can provide robust reasoning why the employee is not a risk taker.

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## Article 3 (1) (f)

***Q2: Can the above criteria be easily applied and are the levels of staff identified and the provided threshold appropriate?***

In principle we support the application of equity trading criteria. However, the criteria relating to the ability of staff members, individually or collectively, to commit the firm to credit or trading book exposures (Articles 3 (1) (f), (g) and (h)) are likely to be complex to implement and may not be aligned with some firms' current risk management systems. In particular we feel that:

- a) There needs to be more detail provided on the definition of credit risk (and market risk). Specifically as regards to credit risk exposures, there is no distinction between the weight that the credit risk component may have in terms of the bank's overall risk profile or a distinction in the underlying business that results to credit risk and the reasons a bank strategically assumes these risks. For example, the differences in the origination of the exposure both in terms of product (e.g. mortgage loans vs. unsecured consumer loans or wholesale finance), or mature economy vs. emerging market.
- b) The threshold also does not differentiate between the different methods and capacity of banks' to identify and measure risk when setting limits internally, for example, banks on the Standardised Approach vs. an Internal Ratings Based (IRB) approach and for which larger banks continue to invest considerably and have to meet 'Use Test' requirements. A risk-sensitive approach remains one of the pillars of the Capital Requirements Directive, provisions of which have been considerably strengthened under the Basel III/CRD IV framework to ensure the identification of material risks and the proper allocation of capital and increase resilience for the banks. The Basel III/CRDIV framework differentiates credit risk exposures via different risk-weights, whilst banks manage risk and set limits internally on the basis of economic capital and risk pricing. The set threshold of 0.25% of CET1 may not necessarily indicate the risk magnitude of the underlying exposure (€ value translated into RWA).
- c) Using CET1 sets a uniform standard however, when developing the strategic plan and risk-appetite of the bank, all loss absorbing capital may be taken into consideration, as well as additional capital buffers which have been significantly under the Basel III/CRDIV framework. (The CET1 threshold as proposed may therefore be too low)
- d) It is likely to be challenging to link an individual's authority to the 0.25% commitment of CET1 as decisions for such credit approval are taken at much higher levels within the organisation and typically pre-determined in risk committees. Credit limits for certain counterparties may also be larger than this threshold, are being monitored in the event of breach, as well as being adjusted on the basis of debt servicing performance, change in market conditions etc. This suggests that there may be a need to establish a % range for the threshold. Likewise, the issuance of new capital or retained earnings may significantly change (potentially on a temporary basis) what the 0.25% translates into in terms of quantum of capital.

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Overall, whilst we welcome the move towards a more standardised approach and additional guidance in this area, we are concerned that a prescribed approach of this sort will not be appropriate for all firms. We would encourage the EBA to provide additional flexibility for firms to agree alternative thresholds with their local regulator, perhaps on a “comply or explain” basis, to recognise differences within firm’s structures and risk profiles.

Within HSBC this captures c.700 employees ranging from junior traders to Heads of Global Products. This proposed definition of risk taker focuses on the individuals who have been set a trading limit to carry out day to day business when the focus may be more suitable for those setting the limits and the risk appetite framework to operate in.

### **Article 3 (1) (g)**

***Q3: Can the above criteria be easily applied and are the levels of staff identified and the provided thresholds appropriate?***

- a) VaR - The market risk framework was significantly strengthened under the Basel 2.5 and Basel III framework to allow for the proper identification and measurement of counterparty and market risk and to provide for enhanced risk coverage for such exposures. For this reason, there is now less reliance on VaR as the sole metric for market risk measurement and the setting of internal limits at trading desks.
- b) Regulatory models - There is likely to be significant variance in the outcomes for the identification of employees, as different trading desks may have trading/VaR limits subject to the range of products they trade, market-making positions, the volatility of the various markets they trade in, as well as the structure of the trades (collateralised; netting agreements; centrally cleared etc.). For risk management purposes, daily market fluctuations mean that a bank may exceed VaR but take immediate corrective action and close positions. This makes more challenging the monitoring of the threshold for the inclusion of identified individuals. Moreover, desks may further hedge trade and portfolio risk to manage the VaR metric after originating trades with a counterparty, therefore the pre-set % may not necessarily reflect the risk-taking of underlying positions.

In addition we note that:

- The Basel Committee’s recent study of market risk models found that regulatory overrides were a key cause of differences between countries. This issue is likely to create major comparability issues in global banks such as HSBC.

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- It should also be noted that under the IMM approach, banks will be required to ensure that their models support adequately the measurement and monitoring of risks, and equal emphasis is put on the development, maintenance and validation of models. By taking an approach that relies on the quantification of one metric and targets (pre-authorised) employees at the trading desks, the current proposal goes against the spirit of the enhancements made in the Basel III/CRDIV framework and the need for senior management to be actively engaged in understanding these risks, model performance and limitations.
- The fundamental review of the trading book is likely to change capital requirements for market risk. We believe that the RTS should build in flexibility to deal with the changes.

### **Article 3 (1) (j)**

It is not fully clear from the draft how firms will be able to practically implement this requirement. For example, it would be helpful to have clarity on how the ability of individuals to implement new products, processes or systems can be categorised or how individuals with these responsibilities can be identified. In addition, we would welcome more details as to the meaning and scope of “collectively” within this sub-paragraph, building on the additional guidance provided at Article 3 (3) (a).

### **Article 3 (2) (a)**

#### ***Q4 a) Is this criterion appropriate to identify risk takers?***

In general we do not believe that a remuneration threshold is the most effective way of capturing individuals who are likely to have a material impact on the firm’s risk profile. For example such criteria may encourage a firm to increase or decrease remuneration in order to ensure that certain employees are not captured by the criteria. In addition, as pay levels (particularly salary and benefits) are often driven by market forces this approach will lead to disproportionate numbers of Identified Staff in certain locations, even though this does not reflect the risk profile of the firm. This is a particular concern in non-EEA territories where pay is typically high, such as the US, as the more onerous pay requirements for Identified Staff will put EEA headquartered firms at a significant competitive disadvantage in these territories.

We also note that the proposed threshold will include a large number of people with no impact on the risk profile of the firm. Though we welcome the ability for these individuals to be disapplied under Article 4 if the individuals have no material impact on the risk profile of the firm, we note that this will create a large amount of bureaucratic administration and activity to document the disapplication of a large number of individuals. We would instead welcome a less prescriptive approach that focuses on measures of risk, rather than quantitative remuneration thresholds.

Our preference is instead for a renewed focus on the qualitative criteria which will apply in identifying those staff who have managerial and/or professional oversight over these decisions and processes. We believe Articles 3 (1) (a) to (e) are positioned to perform this purpose more effectively (subject to our comments provided under questions 1-3) than monetary thresholds.

***Q4 b) Are the thresholds set in the criterion appropriate?***

The criteria as currently defined are likely to capture a significant number of HSBC employees globally. We believe that a very large proportion of these should not be included as MRTs because the risk management processes in place at HSBC would prevent them from influencing the firm's risk profile, as defined under the remaining criteria. As noted above, a set threshold also does not recognise the pay market in different territories (often driven by external factors such as the cost of living).

***Q4 c) What would be the number of staff members identified in addition to all other criteria within the RTS?***

*c.3,600 employees*

***Q4 d) What would be the additional costs of implementation for the above criterion if an institution applies Article 4 in order to exclude staff from the group of identified staff?***

The additional costs of implementation are due to be significant given the number of staff likely to be captured under Article 3 (2) (a). As explored in more detail under our response to Article 4, the qualitative process for identifying/excluding potential MRT's is complex and would almost certainly represent a significant additional administrative burden for HSBC.

## **Article 3 (2) (b)**

***Q5 a) Can the above criterion be easily applied?***

We believe that one unintended consequence of the criterion which links the pay of an individual with remuneration paid to other individuals in previous years (Article 3 (2) (b)) will be to make firms hesitate before paying a low or zero bonus to an MRT, since that would have the effect of bringing other employees into the MRT category in future years. This runs counter to the requirement in the Remuneration Code that firms should have fully flexible variable

remuneration policy, which includes the ability to pay no variable remuneration (SYSC19A.3.44 R).

***Q5 b) Would it be more appropriate to use remuneration which potentially could be awarded as a basis for this criterion?***

In light of the above this would appear to be a more appropriate criterion to apply, however we have a number of concerns related to implementation, as explored below.

***Q5 c) What would be the difference in implementation costs if the potentially awarded remuneration would be used as a basis?***

The criterion “remuneration which could potentially be awarded” will pose significant implementation challenges for HSBC because our oversight of this figure is not fixed as an absolute value, but varies year on year dependent upon business performance, market data, retention risk and other underpinning factors.

### **Article 3 (2) (c)**

***Q6: Can the above criterion be easily applied and are the threshold and the levels of staff identified appropriate?***

We recognise that a monetary threshold is likely to form part of the threshold for identifying MRTs. We believe that the €500,000 threshold could be raised given the detailed non-remuneration criteria that will be in place for identifying MRTs. The definition of remuneration (and in particular its definition as historical remuneration) is welcomed, as a forward looking definition would be practically difficult to measure and monitor.

We also note that this threshold may capture individuals who have no material impact on the risk of the firm, particularly in markets in which compensation levels are high. We would therefore suggest that some ability to exclude individuals who it can be demonstrated do not meet the risk criteria of a material risk taker should be incorporated into this requirement.

### **Article 3 (2) (d)**

***Q7: Can the above criteria be easily applied and are the levels of staff identified appropriate?***

While we believe it is more appropriate to apply relative rather than absolute quantitative criteria, this requirement is likely to capture around 1,200 HSBC employees globally which would represent a significant administrative burden to HSBC. If this criterion is to apply then we would suggest it is significantly reduced to ensure that it is manageable for firms.

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Overall we believe that this proposal would damage the competitiveness of EU banks within both the EU and non-EU markets.

### **Article 3 (3) (a)**

It is not fully clear from the wording of the draft legislation how this would be applied in practice, given that it could provide extremely broad scope for the inclusion of individuals who would otherwise have very limited influence over the firm's risk profile.

### **Article 4**

This Article, which allows firms to apply two further tests which should allow two of the four quantitative criteria (Articles 3 (2) (a) and (b)) to be disapplied in many cases is welcome, but we would welcome further guidance as to how these criteria should be applied practically within firms.

For example, does the final point in sub paragraph (b) imply that the requirement to apply these standards in jurisdictions where pay levels are different from those in the EU may be waived, where this can be justified?

We would also note that the process of individually documenting the rationale for excluding a very large population of individuals (based on the requirements of Article 3 (2) (a)) will be extremely bureaucratic and administratively burdensome for firms, particularly as many individuals captured by this article will be relatively junior and will clearly have no material impact on the risk profile of the firm.

Yours faithfully



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