Chairperson of the European Banking Authority

One Canada Square (Floor 46)
Canary Wharf
London

E14 5AA

October 2015

Dear Sir/Madam:

**Regulatory Technical Standards (RTS) on conditions that competent authorities shall take into account when determining higher risk-weights and higher minimum LGD values – consultation paper**

HSBC welcomes the opportunity to respond to the European Banking Authority’s (‘the EBA’) consultation paper EBA/CP/2015/12 ‘Draft Regulatory Technical Standards on the conditions that competent authorities shall take into account when determining higher risk-weights, in particular the term of “financial stability considerations” under Article 124(4)(b) CRR and the conditions that competent authorities shall take into account when determining higher minimum LGD values under Article 164(6) CRR’ (‘the consultation’).

We welcome the harmonisation of the circumstances and criteria by which competent authorities can increase standardised risk weights and Internal Ratings Based (‘IRB’) LGD floors across Europe. We believe that this consultation should help to achieve consistency and transparency in the approaches used across member states when making increases to capital requirements by these means. However, there are a number of areas where we feel further consideration is required to ensure a robust approach is delivered. These are outlined below, with answers to specific questions in the appendix.

We would be pleased to discuss our comments further if this would be helpful to you and your colleagues.

*Use of LGD to regulate systemic financial stability*

Our main concern with the proposals in the consultation is the emphasis that is placed on the role of LGD in the future stability of the financial system. We agree that risk weights for retail exposures secured by residential or commercial immovable property must be appropriate, however we question the effectiveness of using LGD as a tool to regulate systemic financial stability. In order to achieve systemic financial stability, there are a number of macro and micro prudential tools available, including stress testing, which we would consider to be more suitable. We ask that the EBA consider these alternatives when considering proposals to use LGD for this purpose, set forward by competent authorities.

*Pro-cyclical effects of the floors*

Our other concerns are around the potential pro-cyclical effects of the proposed floors. When a ‘real estate bubble’ is identified, there is a concern that a competent authority will impose a higher LGD or risk weight floor, which institutions will have to capitalise by rationalising their mortgage portfolios, causing lending rates to decrease, affecting supply and demand and consequently prices in the immovable property market. We have concerns surrounding the benefits of using a higher floor to deflate a ‘real estate bubble’ at different stages of the economic cycle, and whether at some stages such intervention will exacerbate a slowdown in the economy and increase risks to interbank lending. We suggest that alternative approaches to adjusting LGD or risk weight floors that could be used to deflate a ‘real estate bubble’ be restricted on targeting new lending, rather than any portfolios as a whole.

*Application of measures for third countries*

EBA Q&As 2013\_65 and 2013\_66 state that competent authorities have the ability to alter risk weights for third countries. We do not see provision for this within the CRR and view this as amending Level 1 text. Even if this is considered to be within the remit of member state competent authorities we have concerns on whether they are best placed to determine such measures for third countries; some of the financial stability considerations are based upon loss rate expectations and expected evolution of prices in markets where the competent authority may have no regulatory authority. We are also unclear how the financial stability considerations, which are based on loss expectations and market considerations, can be applied to third countries as a whole. There is the probable consequence that different member states could come to different conclusions on third countries giving rise to issues maintaining a “level playing field”. We would suggest that any amendments competent authorities can make are restricted to their own jurisdiction and third countries are treated through appropriate equivalence treatments, similar to those used elsewhere in the standardised credit risk framework. We also note that the RTS only covers higher risk weights determined under financial stability considerations, whilst the CRR also allows for stricter criteria to be set. Although the CRR only requires the EBA to cover setting of higher risk weights, it is unclear what rationale would be used for setting stricter criteria. We would suggest that the same financial stability conditions should be applied for the setting of stricter risk weights.

*Implementation*

Lastly, in order for institutions to implement required changes promptly and effectively, a robust communication system used to notify institutions of amendments is required, with a well-maintained list of required amendments held at the EBA level and sufficient alerts of changes to requirements published in a timely manner.

Yours faithfully,

Bruce Fletcher

Group General Manager and Chief Risk Officer

Global Retail Banking and Wealth Management

**Appendix I – Conditions that competent authorities shall take into account when determining higher risk-weights and higher minimum LGD values:**

**Responses to the specific questions**

**Q01: Do you agree with the three main categories of conditions specified for the setting of higher risk weights (paragraph 1) and the setting of higher minimum LGD values (paragraph 2)?**

We are in broad agreement with the three main categories given. However, we are concerned around the timescales for identification and implementation of necessary adjustments as identified and communicated by competent authorities. As discussed in the consultation, the adjustments of standardised risk weights and minimum LGD floors according to the criteria set out may be pro-cyclical; consideration should be given as to how these adjustments will function in combination with for example, the counter-cyclical capital buffer. Further clarification on how the process would practically define an appropriate LGD would be of benefit.

**Q02: Do you agree with the conditions for specification of the loss experience and the loss expectations? Do you agree with the adjustments allowed to be made to the loss experience on the basis of the forward-looking immovable property market developments?**

In principle we agree with the conditions for specification of loss experience and loss expectations consultation in the consultation. However, we feel that it is important to ensure harmonisation and consistency in how specifications are made by competent authorities, in particular considering any judgemental aspects contained in those specifications. We would also encourage consideration on how adjustments made will ensure that standardised and IRB approaches are treated fairly.

**Q03: Do you agree with the indicative benchmarks for the assessment of the appropriateness of the risk weights and to guide the setting of higher risk weights across**

**immovable property markets in different member states as specified in Article 4(3) and 4(4)? What levels of these indicative benchmarks would be most appropriate and why?**

We would encourage the EBA to undertake the necessary data collection and surveys, and consult competent authorities in member states in order to set appropriate indicative benchmarks.

**Q04: Do you agree with the specification of the term of “financial stability considerations”?**

We agree with the specification of “financial stability considerations”. We consider that an increased LGD floor may not be the ideal mechanism to control the overall systemic financial stability. However, in circumstances where it is deemed appropriate to increase standardised risk weights or LGD floors, the “financial stability considerations” described will inform the decisions made.

**Q05: Do you agree with the other conditions for the setting of higher risk weights? (Please provide your feedback related to the indicative benchmarks (in Article 3(3) and 3(4)) in your response to Question 3 above.)**

We would like to emphasise that the conditions for setting higher risk weights be clearly defined, and the populations for which increases are made are truly homogenenous according to the criteria specified (including loss experience and expectation). This should help to ensure that proposed increases do not disproportionately increase capital requirements for lower-risk portfolios than higher-risk identified within the same population identified for higher risk weights.

**Q06: Do you agree with the conditions for specification of the exposure weighted average LGD and the LGD expectation? Do you agree with the adjustments allowed to be made to the average exposure weighted LGD on the basis of the forward-looking immovable property market developments? Do you agree that it is not appropriate to set indicative benchmarks for the setting of higher minimum LGD values because of the specificities of national immovable property markets and because of the relationship of the LGD parameter with the other internal model parameters?**

We agree with the conditions for the specification of the exposure weighted average LGD and the LGD expectation, and adjustments allowed to be made to the average exposure weighted LGD on the basis of the forward-looking immovable property market developments. Regarding the setting of indicative benchmarks for the setting of higher minimum LGD values, it is agreed that there are a number of specificities of national immovable property markets, and competent authorities within member states would be expected to have different interpretations of loss experiences and different predictions for future loss expectations; this may limit the usefulness of any indicative benchmarks set. Similarly for institutions within member states, the relationship between the LGD parameter and other internal model parameters will affect the degree to which a higher LGD floor will affect capital requirements of exposures within the homogeneous populations identified.

There are concerns that the setting of higher risk weights and LGD floors may not be consistent across member states, and the EBA is requested to consider measures with which to control for such a scenario and the subsequent effects.

**Q07: Do you agree with the other conditions for the setting of higher minimum LGD**

**values?**

We encourage the same rigour in identifying homogeneous populations for higher minimum LGD values as for those receiving higher risk weights in Question 5.

**Q08: Do you have any suggestions on the Impact Assessment?**

We agree with the proposal for a cost-benefit analysis. The proposal to collect data of loss experience, immovable property market prices, loan-to-value ratios and the debt-service-to- income ratios is consistent with other data collected for the surveys undertaken for proposals to change the standardised approach and associated capital buffers, and should give meaningful insight and encourage consistency with those proposals.