HSBC

European Banking Authority
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Confidential

EBA/CP/2014/32 – Draft Regulatory Technical Standards on materiality threshold of credit obligation past due

Dear Sir/Madam

HSBC welcomes the opportunity to respond to the European Banking Authority ('EBA') consultation paper on materiality threshold of credit obligation past due ('CP').

HSBC is one of the world's largest banking and financial services organisations with assets of US$2,754billion at 30 June 2014, serving customers worldwide from over 6,200 offices in 74 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 how materiality thresholds are implemented across the EU. However, we are concerned that the proposal for a cap which requires national competent authorities to set their own respective fixed threshold amounts and/or percentages will create undue costs for banks that currently adopt a more conservative approach than that which might be proposed by the Regulators, without having a significant impact on comparability. With this in mind, it is worth noting that as HSBC is headquartered in the European Union, all CRD IV[1] requirements (including EBA Level 2 measures) will apply on a consolidated basis and therefore to all global operations, including those outside of Europe. As a number of portfolios in HSBC are regulated by more than one competent authority in numerous global locations, there is a need for alignment across a number of competent authorities.

In order to achieve maximum RWA harmonisation and comparability we would recommend, rather, that the cap set by EBA be the same cap which is uniformly implemented by national competent authorities across all EU jurisdictions. Requiring competent authorities to implement materiality thresholds as caps, rather than as a fixed amount or percentage, will help to ensure greater comparability and alignment across a large number of national competent authorities while reducing the operational burden for implementation. This would also give firms which choose to adopt a more conservative approach the flexibility to do so.

[1] The CRD IV package comprises the recast Capital Requirements Directive and the new Capital Requirements Regulation.

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The Consultation clearly envisages that there will be differences in the thresholds set by competent authorities within Europe. However, the EBA seems content that if this happens within the proposed thresholds there will be a sufficient level of comparability throughout Europe. It is therefore unclear why competent authorities should require banks within their jurisdiction to adhere to any fixed thresholds, rather than caps, which would inevitably result in significant implementation costs for almost every bank.

With regards to implementation, the proposals will lead to a change in the definition of default and as such, will have impacts on historic, ongoing and future model developments, as well as on recalibrations going forward. We are concerned that the proposed retrospective application of the proposals which would require an adjustment of data history, would involve reprocessing large amounts of data in view of the requirements to hold several years of data history for capital models. The timings of this change will need to be carefully considered with a generous phase-in and/or transition period, especially considering that many institutions are already embarking on far-reaching model redevelopment plans with regard to CRD IV requirements to harmonise the definition of default for retail exposures from 180 to 90 days past due. We would also encourage EBA to introduce language which ensures that during the interim phase-in and/or transition period, while the necessary changes are being made to update wholesale and retail credit models, firms are not subject to overly conservative or penal backstop measures, such as floors.

We have summarised our key comments below and provide further detail on the consultation questions in the appendix to this letter:

Fixed thresholds

While we have no objection to the proposal to set a materiality threshold that is composed of both an absolute and a relative threshold, we believe that to achieve maximum comparability competent authorities should be strongly advised to implement the EBA thresholds as caps rather than as a fixed amount and percentage.

If competent authorities within Europe are required to take on the EBA cap, divergences will be significantly minimised and the operational burden on firms will be more manageable.

Against this background, rather than competent authorities seeking to determine fixed materiality triggers, a more effective approach would be for competent authorities to align with the EBA materiality cap. Setting fixed thresholds would have the effect that banks which apply a more conservative threshold than that set by its regulator would need to update all operating IRB models and seek approval by the regulator, even though impacts on models and RWAs would likely be insignificant and the differences in the materiality threshold would continue to be within a range that is seen as acceptable for comparison within Europe.

Adjustment of historical data

Our concerns is that the operational costs needed to adjust all historical data to align default history to the new threshold and to recalibrate parameters to reflect the new default definition will far exceed any enhancement in risk and capital measurement.

As stated above, adjusting all historical data with a revised default definition would be a very time-consuming task. Some banks may currently operate a more conservative approach to defining default than that proposed, including banks that may not apply any materiality thresholds in defining

default for all or part of their portfolios. It appears counterintuitive if such banks would have to modify and/or redevelop their systems to include a fixed materiality threshold that would be less conservative than their current approach, and therefore not in line with their preferred risk appetite.

Finally, the timing of this change should be carefully considered in light of other pre-existing modifications to our A-IRB framework (harmonisation of definition of default for retail exposures from 180 to 90 days past due), as well as those which are forthcoming (revisiting of definition of default). It is also worth recalling that LGD models require at least seven years of data history.

We hope you find our comments useful. We will be glad to discuss any aspects further if that would be helpful.

Yours faithfully,

Alan Smith

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Appendix

Responses to the specific questions

Q01: Do you agree with the approach proposed in the draft RTS (option 1) that default should be recognized as soon as one of the components of the threshold (absolute or relative limit) is breached? Or would you rather support the alternative option, i.e. recognition of default after both thresholds are breached (option 2)?

It is recommended that the absolute and relative thresholds are determined by considering the occurrence and materiality of technical defaults (and other similar conditions which may not be considered a real default), and the sizes of exposures within portfolios subject to this regulation. This will ensure that the materiality thresholds are fit for purpose, namely, effectively separating technical defaults and short-term cures from real defaults, and ensuring timely identification of real defaults.

Internal materiality thresholds within HSBC and other regulated institutions that drive the financial viability of collections and recovery activity, would affect the motivation for treating exposures in default, classification as real default, and thus the real default rates for different portfolios. Once sufficient insight has been obtained, the decision whether to choose from option 1 (either absolute or relative limit breached), or option 2 (absolute and relative limit) can be made effectively.

In the absence of such analysis, and due to variance across personal, wealth and business portfolios, it would be sensible for competent authorities to implement the thresholds as caps, allowing reasonable flexibility across different portfolios and regulated institutions. Furthermore, we support option 2 over option 1.

Q02: Do you agree with the proposed maximum levels of the thresholds?

The percentage trigger for the relative threshold of 2% appears high for large exposures in the wholesale credit market. We would suggest reducing this threshold to a level that is meaningful for large exposures which will also maximise comparability of own funds requirements for credit risk; however, without proper analysis suggesting an alternative figure presents a challenge

For retail exposures, thresholds higher than 200 EUR and 2% would not be desirable. For smaller exposures with longer repayment terms, higher thresholds would delay the classification of delinquent accounts as 90 day default by a number of months; in some instances, accounts can have made zero payments for 180 days before the thresholds of 200 EUR and 2% are reached. This appears counter-intuitive given the CRDIV requirement to move from a 180 to 90 day default definition for the majority of retail exposures, and is also not consistent with internal triggers for debt recovery.

Q03: How much time is necessary to implement the threshold set by the competent authority according to this proposed draft RTS? Given current practices, what is the scope of work required to achieve compliance?

Any adjustment of the data history for the revised materiality thresholds would be a very time consuming manual task that would take several years.

Given that LGD models require at least seven years of data history a retrospective application of the new guidelines would require the manual review of seven years of data history for each customer. The task would be further complicated by the fact that some customers who were not identified as being in default might be classified as being in default once the revised thresholds are applied.

The change in the default definition will also potentially have impacts on future model developments, recalibrations, and reporting going forward not to mention subsequent supervisory approval of updated models going forward. The timings of this change in relation to these activities will need to be considered.

Considering all of these factors, as well as pre-existing and forthcoming changes to the A-IRB framework, we think it reasonable that these changes be given a sufficiently long phase-in where regulated institutions will have the flexibility to prioritise redevelopment efforts based on model materiality.

Q4. Do you agree with the assessment of costs and benefits of these proposed draft RTS?

We agree that the benefit of establishing harmonised criteria for setting the materiality thresholds for past due exposure is greater comparability of own funds requirements for credit risk. It is unclear, however, how the proposal would reduce the administrative and operational burden to comply with different regulatory frameworks in different Member States, and indeed globally, given that each national regulator will have to set their own thresholds within the proposed EBA framework. Given that the proposal currently suggests that national regulators should determine fixed thresholds rather than caps it is unlikely that all regulators will define the same thresholds and the jurisdictional differences would therefore remain. Our response to Q02 therefore suggests that the thresholds should be used as caps and that the trigger for the relative threshold be set below 2% in order to minimise variability of own funds requirements for credit risk.

However it is recognised that harmonising criteria for setting materiality thresholds will increase comparability of own funds requirements for credit risk. As stated previously, it should be noted that some portfolios in HSBC are regulated by more than one competent authority, and in such cases, there is a need for alignment across a number of competent authorities for the same portfolio.

While the assessment states that the adjustment of data and recalibration of risk parameters may impose a significant operational burden on the banks that use the IRB approach we do not believe that this sufficiently expresses the excessive cost and operational burden in relation to the benefits achieved. Similarly, the re-adjustment of all historical data will be a lengthy and time-consuming task which adds to the operational burden intimated above.

Q5. What is the expected impact of these proposed draft RTS?

The impact of this change cannot yet be fully determined. The size of the impact for retail portfolios would depend on how much any materiality thresholds used in current modelling, calibration and reporting processes, differ from those that will be enforced by competent authorities as a result of this consultation paper. Broadly speaking, the change in default definition due to this materiality threshold would be expected to have minimal impact on cost of own funds for credit risk and we do

not generally expect that the proposal will have a significant impact on exposures classified as in default; however, this is very difficult to confirm in the absence of extensive manual checking.

It is estimated that the change to the default definition could have considerable operational impacts. Further clarification of the mandatory requirements and their ramifications for model development, model calibration and reporting is sought. A mandatory requirement for models to be developed and calibrated on this new definition and for reporting to be modified, could require the processing of huge amounts of data, significant re-modelling activity, a vast number of historic recalibrations, and changes to a number of other operational processes.