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26 March 2015

Dear *Bill,*

Capital Floors: the design of a framework based on standardised approaches – consultative document

HSBC welcomes the opportunity to respond to the Basel Committee on Banking Supervision's ('the Committee') consultation paper '*Capital floors: the design of a framework based on standardised approaches*' ('the consultation').

We share the Committee's view that the current Basel 1 capital floor should now be reviewed. The Basel 1 floor was originally a temporary safety measure to ensure capitalisation levels would remain appropriate upon transition to Basel 2. Since then, a number of additions to the regulatory regime have been implemented, resulting in the Basel 1 floor becoming increasingly dislocated from the capital levels now required.

While we agree with many of the Committee's objectives, we believe that the case for the continuation of a capital floor has not yet been proven. In many cases, the objectives are already addressed by other components of the prudential regime, including higher minimum requirements, improved capital quality, the leverage ratio, additional capital buffers and the stress-testing regimes. Furthermore, regulatory initiatives aimed at reducing risk weighted asset ('RWA') variance and improving comparability are either underway or are forthcoming. Where shortcomings continue to be present, these should be addressed within the internal model approaches directly or through adjustments in existing regulatory tools, rather than via a capital floor. This is a better route to improving sensitivity to risk. Floors and simple leverage ratios are less risk sensitive, and incentivise greater levels of risk taking making the financial system inherently less stable.

For this reason, the framework should incorporate positive incentives for continuous improvement in risk sensitivity and accuracy of the modelled approaches, and that these are not undermined through the use of capital floors. The use of a floor may significantly

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reduce the incentive for banks to continue to invest in internally modelled approaches for capital purposes. We are also concerned that the regime proposed by the Committee may result in a deterioration of banks' risk profiles which would stifle credit to low risk (low return) exposures and constrain market making activity.

We support the Committee's objective of improving comparability between banks; however we do not believe that this will be achieved through a standardised floor, due to the number of national discretions within the revised standardised approaches which will consequently be embedded into a capital floor.

Given the level of regulatory change currently underway, we would urge the Committee to defer the decision on the need for a capital floor and its calibration until the many moving parts in the new regime have settled and a thorough and appropriately timed Quantitative Impact Study ('QIS') has been completed.

The case for a new capital floor

We consider that the case for an additional capital floor is not proven.

As identified in the consultation paper, many of the model risk issues identified as objectives of the regime have already been addressed through the leverage ratio framework. We consider that the additional perceived shortcomings outlined in the consultation are already being addressed through other new supervisory tools at the disposal of regulators. These tools include:

- the use of stress testing as an essential tool in capital planning and providing forward insight and challenge into modelled risks;
- enhanced capital requirements through the use of capital buffers;
- introduction of requirements in the EU implementation of Basel 3 to scale up RWAs for exposure classes that normally exhibit low RWAs from internal models, e.g. asset value correlation multipliers for financial institutions;
- the use of macro prudential tools such as sectoral capital requirements and portfolio floors e.g. use of loss given default ('LGD') floors, already serve to address variability and reinforce the risk weighted framework;
- recently finalised Pillar 3 disclosure requirements which will significantly increase granularity and standardisation of disclosures and seek to enhance and improve comparability and transparency of internally modelled RWAs;
- Pillar 2 assessment to deal with aspects of model related risk, such as credit concentrations; and
- supervisory review processes intended to interrogate internal models to improve model integrity and credibility, thereby addressing any assumed incentive-compatibility issues.

Any shortcomings in these existing methodologies should be addressed directly in improvements in internal approaches, or via adjustments in existing regulatory tools rather through the application of a floor. For example, a more logical starting point would be to revisit the internally modelled approaches, with a view to introducing improved requirements where deemed necessary.

Additionally, supervisory processes could be enhanced to ensure that implementation by institutions is in line with these minimum requirements. In particular, regulatory initiatives currently being undertaken by the European authorities, such as benchmarking exercises, and improvements to the internal model assessment methodology are a welcome step forward in trying to address the underlying problems directly.

The introduction of capital floors before these reforms are completed, not only undermines ongoing work to improve internal models, but also undermines the objectives discussed in the consultation paper.

While we agree that the current level of variability of reported RWAs by different banks may be undesirable, it is important to note that

- around half the variance stems from differences in supervisory approaches, which could be better aligned, and
- some variance is reasonable and to be expected as a natural product of differing business models, risk appetite, portfolio diversification, and internal risk management and governance.

Use of the standardised approach

Additionally, we do not support the standardised approaches as an appropriate basis for the calculation of a capital floor. Although the proposed changes to the standardised approaches could be considered more risk sensitive than the current regime, a floor based on these effectively favours a less sophisticated design, over more risk sensitive, widely scrutinised, internally modelled approaches. With a floor in place, it is not evident why institutions would or should continue to invest in internally modelled approaches for capital purposes.

Banks using internally modelled approaches have devoted significant time and resource to improving the sophistication of their risk management systems. There is a danger, therefore, that introducing a capital floor based on a standardised approach would remove precisely the incentives which have driven better risk management. This could result in a violation of the 'use test' principle and ultimately break the linkages between risk management and capital. This would create a dynamic in which regulatory capital requirements would increasingly fail to reflect economic capital needs or the true level of the underlying risk. Changes in the underlying risk of a given asset class – such as the deteriorating credit quality of sub-prime lending in the US which was observable before the crisis – would not trigger the adjustments necessary to keep the system stable.

There is also the risk that capital floors may incentivise some institutions to prioritise modelling efforts in areas where the capital floor is not a binding constraint. This may have the inadvertent effect of detracting from model quality where internally modelled approaches remain in place and mask any associated impact. This effect is likely to be further exacerbated if capital floors are imposed at a risk category or an exposure class level. For example, an artificially high floor imposed on portfolios or classes of exposures which attract a wide range of modelled risk weights under the advanced approach, may create the unintended consequence of incentivising institutions to increase the average level of modelled risk to the level of the floor.

Comparability

The consultation assumes that applying the standardised approaches will result in full comparability of reported bank capital ratios. We do not believe that this will be achieved due to the divergent national implementation inherent within the standardised approaches as is noted in the Committee's Regulatory Consistency Assessment Programme. For example, in the US, some institutions continue to calculate RWAs using Basel 1 approaches rather than using Basel 2 standardised approaches.

Furthermore, the use of risk drivers, as currently drafted into the revisions to the standardised approaches, would result in divergent interpretations. Such divergence then will be embedded into any capital floor rendering it non-comparable across jurisdictions and institutions. This is further compounded by the fact that differing capital floors currently exist in certain jurisdictions, which in our view will be more onerous to change e.g. the US has only recently introduced a capital floor through the Collins Amendment which excludes capital requirements for operational risk and credit valuation adjustments.

An additional complexity is that international organisations will be required to operate multiple floors for solo and consolidated reporting, even before the calibration of a capital floor is itself, considered.

Lack of disclosure requirements

The consultation contains little information on the disclosure requirements related to the application of the floor. Without this it is difficult to assess whether the Committee's goal of increased comparability would be met.

The inference from paragraphs 22 and 27 of the consultation is that the output will be shown as a cap on capital ratios i.e. capital ratios will be disclosed on a 'before' and 'after' basis. Where the capital floor is binding, an increase in RWAs will reduce the capital ratio and require extensive explanation within disclosures. In particular, a simple disclosure will tell investors little about the varying concentrations of counterparty type, industry lending or products which are far more likely to impact the actual capital ratio than a ratio which is bound by a capital floor.

Furthermore, it will be important to understand the extent to which the floored capital ratio would interact with other requirements, in particularly capital buffers, and requirements for total loss absorbing capacity. In our view, the calculation of a capital floor should be clear and simple to apply and explain. This would be achieved if the floor was expressed as an additional capital requirement rather than a mechanical substitution of RWAs or disclosures of multiple capital ratios.

It is therefore important that the Committee clarifies these disclosure requirements as soon as possible.

Calibration

The consultation does not cover the associated calibration of the capital floor, which makes a comprehensive review of its conceptual design difficult. We believe that the assumption that calibrating at the aggregate level and at the risk-based level in such a way as to keep effects on capital entirely neutral, is unachievable across different institutions.

Variations in the dispersion of exposures and RWAs across different organisations will lead to the calibration of aggregate floors and risk category floors having dramatically different outcomes, often with minimal deviation in actual risk. Appreciating that the Committee will have to calibrate to an appropriate norm, when reviewing the design of the floor, individual institutions cannot simply set aside the effects. We would highlight that if the Committee intends to finalise calibration by the end of 2015, this will be in advance of the transposition and implementation of the underlying standardised approaches, therefore it is unclear how a meaningful calibration can be achieved within such timescales.

A calibration determined using approximations and without the actual transposition of the revised standards into national law, would be significantly less defensible than the internally modelled approaches that the floor will be superseded in the capital framework.

We would recommend that calibration is determined after the standardised approaches have been transposed into national law and impacts of the revisions can be assessed. At which point it would be highly beneficial for detail of the calibration methodology to be made transparent.

Implementation

The implementation of this proposed floor regime for banks utilising internally modelled approaches is a considerable undertaking and will require significant lead times to make the necessary changes to reporting systems and processes to run two sets of RWA calculations. Given the far-reaching consequences of the revision to the standardised approaches and the capital floor, a more systematic and suitably phased finalisation of requirements and subsequent implementation would seem appropriate.

Potential Macro-Economic Implications

There is a theoretical argument, with which we broadly concur, that banks can hold much higher levels of capital without causing significant asset repricing; however, while a change of capital ratio may not impact pricing, it will impact the volume of assets that a bank can hold. The result will be that higher ratio requirements significantly reduce the capacity of banks to initiate new loans.

Our aspiration is that the divergence of views between regulators and the industry on the issue of bank capital ratios can be resolved through dialogue on two issues: optimum leverage across the financial system – since a healthy economy requires leverage in its financial system or it cannot grow – and ways to improve the RWA framework.

Conclusion

We do not agree with the view that capital floors are an integral component of the capital framework and consider that the case for a floor remains unproven. In any case, we would request the Committee to defer judgement on the need for a floor once the other components of the regulatory regime are designed and implemented. If, at this juncture, it is concluded that a floor is required, any calibration should only be finalised following a dedicated and appropriately timed QIS.

Last month you kindly hosted a meeting of HSBC delegates to exchange views on the issues related to the capital framework, including the internally modelled approaches, the proposed changes to the standardised approach and the capital floors. I hope that this letter provides further elaboration on our perspective on the latter issue. We would be pleased to discuss our comments further if this would be helpful to you and your colleagues.

Yours sincerely,



Russell C Picot

Appendix I – Capital floors: the design of a framework based on standardised approaches: Responses to the specific questions

Q01: Assuming the respective floors were calibrated to achieve the same level of required capital, what are your views on the relative merits of a risk category-based floors and an aggregate RWA-based floor? What are your views on a floor based on exposure class?

We do not believe that a capital floor based on the standardised approaches constitutes an enhancement of the risk based capital framework. However, if the Committee decides to implement this, in the absence of further information, the aggregate floor would appear to be preferable design of the options provided. This view is subject to the calibration of such a floor, which is yet to be consulted upon.

Whilst disclosure requirements are unclear, an aggregate floor would appear to be simpler and provide somewhat, easier comparability, across organisations, which are consistent with the revised Pillar 3 guiding principles.

We note, however, that calibration has been decoupled from this question and the assumption that its effects would be capital neutral, is conceptually unsound. Variations in the dispersion of exposures and RWAs across different organisations will lead to the effect of aggregate floors and risk-level floors being dramatically different; this cannot simply be discounted when designing the floor.

It is important that a further consultation on calibration is undertaken, once the revised standardised approaches have been finalised. This should include a dedicated QIS, which would allow us to provide an informed view on the impact and preference of a floor based on risk categories or on an aggregate basis.

The calculation of a capital floor should be clear and simple to apply and explain, should be expressed as an amount of additional own funds requirements, and should not involve a mechanical substitution of RWAs, which results in a number of different ratios being disclosed.

We are not supportive of floors by exposure class. In addition to the arguments above, an exposure class floor is unlikely to provide direct comparison, due to inconsistent definitions of exposure classes. Furthermore, as is noted in the main body of this letter, exposure class floors are synonymous with sectoral capital requirements and there are a number of asset class floors already embedded within the existing framework.

Q02: What are your views on the relative merits of the two options for adjusting for differences in the treatment of provisioning for credit risk?

We do not believe that a capital floor based on the standardised approaches constitutes an enhancement of the capital framework. However, if the Committee proceeds to implementation, further detail will be necessary on the options provided. The stylised

examples provided are too simplistic and do not allow for a full assessment of their impacts, this results in a number of questions which need to be addressed before we are able to provide an informed view, in particular:

- the examples do not currently take into account circumstances where expected losses exceed provisioning;
- the examples provided also assume a bank has general provisions as a key line item to adjust for, however under IAS 39 credit risk provisions would be considered specific provisions rather than classified as general provisions eligible as own funds Tier 2. Furthermore, under the EU implementation of Basel 3, all impairments are considered specific credit risk adjustments;
- it will also be necessary to consider any impact resulting from the future application of IFRS 9;
- the examples do not take into consideration the proposed difference in design of the capital floor – i.e. risk category floor versus aggregate floor;
- under both options, it is unclear in circumstances where the capital floor is a binding constraint, whether adjustments to either capital resources or the RWA calculation would be required for other regulatory requirements e.g. for the purposes of large exposures, RWA requirements for total loss absorbing capacity ('TLAC') purposes etc; and,
- Option 2 assumes a RWA conversion ratio of 1250%, which does not take into account banks' effective capital requirements which are in practice significantly higher than 8%.

Q03: Do you have any other comments regarding the design of the capital floor?

We do not observe any compelling reasons for adopting a capital floor, particularly when based upon standardised approaches with less sophisticated design, calibrated generically over the more risk sensitive, more widely scrutinised internally modelled approaches.

We have no further comments over and above those stated in the main body of this letter, with regard to the design of the capital floor.