15 June 2018

General Manager Policy Development
Policy and Advice Division
Australian Prudential Regulation Authority
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By email: ADIpolicy@apra.gov.au

Dear Sir/Madam,

Discussion Paper
Revisions to the Capital Framework for Authorised Deposit-Taking Institutions

HSBC Bank Australia Limited and The Hongkong and Shanghai Banking Corporation Sydney Branch (collectively 'HSBC') welcomes the opportunity to provide comments on the Discussion Paper *Revisions to the Capital Framework for Authorised Deposit-Taking Institutions*.

In Australia, the HSBC Group offers an extensive range of financial services through a network of 36 branches and offices. These services include retail and commercial banking, financial planning, trade finance, treasury and financial markets, payments and cash management and securities custody. HSBC Holdings plc, the parent company of the HSBC Group, is headquartered in London. The Group serves customers worldwide from around 4,000 offices in 70 countries and territories in Europe, Asia, North and Latin America, and the Middle East and North Africa. With assets of US$2,522bn at 31 December 2017, HSBC is one of the world's largest banking and financial services organisations.

In relation to the Discussion Paper HSBC has participated in the industry discussions led by the Australian Banking Association (ABA) and largely support the industry submissions.

We have undertaken a review of the Discussion Paper and write to provide our feedback. Please note that we have not directly addressed each of the Consultation questions under Section 9, and instead have directed our feedback towards specific areas relevant to HSBC Australia.

General Comments

- HSBC supports a globally consistent implementation of the Basel standards to support international comparability. Any variations to risk weights or credit conversion factors (CCF) should be limited and justified, pertinent to the local context without marginalising specific borrower segments or limit the banks' capacity to prudently adjust its own credit policies as market conditions evolve. In particular, the proposed CCF increases beyond BCBS will have significant implications on the wider economy to the detriment of the consumer.

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- We recommend the implementation timeline in Australia be aligned with the global implementation timeline as provided in the Basel III reform package: the implementation date should be 1 January 2022, instead of 1 January 2021. The package is a significant change for all banks globally and the impacts in many areas remain unclear. Earlier implementation will put Australian banks at a disadvantage with a new capital regime which is not yet fully understood and will also create level-playing issues with banks in other regions. Sufficient lead time is required to perform necessary system development and testing, as well as business strategic reviews to implement cost allocation, product pricing and required customer system enhancements. HSBC and other global banks face particular challenges in implementing system changes to a different timeline to globally agreed timelines.

- Proposed changes will severely deplete HSBC Australia capital ratios by approximately 2.4% if those reforms are adopted in full as proposed, compared to BCBS neutral impact on capital ratios. Any increase in capital requirements beyond the unquestionably strong capital ratios announced in 2017 will have wide repercussions across the industry and the economy.

- Some of the proposed criteria to define Non-Standard mortgages lack objectivity or present operational challenges to implement. HSBC recommends to narrow selection to a well-defined criteria which banks can implement uniformly without differing interpretations.

- HSBC supports alignment and consistency on undrawn CCFs between IRB and Standardised approaches.

- Transitional arrangements are a critical element of the proposed capital reform that needs to give consideration to implications on customers and the banks. The consultation has not explicitly elaborated on transitional arrangements however we provided some comments on what we would consider a sensible approach to limit undue consequences on customers and the banks.

More detailed observations are contained below.

Feedback on Loan-to-Valuation Ratio (LVR) / Risk-Weighted Asset (RWA) matrix

- LVR Segmentation – We suggest the LVR banding is varied to cater for the Australian context by substituting LVR bands ≤ 50% and ≤ 60% by LVR bands ≤ 60% and ≤ 70% respectively. We note that this is particularly relevant to the Australian market which has significant concentration within the 60%-80% LVR band. We believe the lack of sharp drops in the local housing prices in excess of 40% supports a benchmark LVR closer to the 70% to 80% for the Australian context.
- Risk Tiering – We recommend APRA consider introducing another risk layer for "Standard" residential mortgages to further differentiate between low, medium and higher risk mortgages, refer proposed matrix table 1. Our suggestion is for the medium risk category to encompass all standard Principal and Interest (P&I) loans with incremental +25% RWA on the anchor point being the low risk category. The higher risk category will incorporate all Interest Only (IO) mortgages. We believe that the suggested risk tiering is more attuned with the current risk assessment and the increased granularity in the risk measurement will benefit the consumer and improve capital risk allocation.

  Alternatively and with a view towards maintaining simplicity, "Low Risk" could include Investment P&I mortgages and RW% would be recalibrated with an increment of 5%

for LVR ≤ 80% and above for the anchor point and flow to other risk tiers accordingly, refer proposed matrix table 2.

Residential Mortgages HSBC PROPOSED_1 RW% - Standardised Approach							
LVR		≤ 60%	≤ 70%	≤ 80%	≤ 90%	≤ 100%	> 100%
		RW %					
Standard (No LMI)	OO P&I	20%	25%	30%	40%	50%	70%
	INV P&I	25%	30%	40%	50%	65%	80%
	Other Resi (IO, SME)	30%	35%	45%	60%	75%	85%
Standard (With LMI)	OO P&I	20%	25%	30%	30%	40%	55%
	INV P&I	25%	30%	40%	40%	50%	60%
	Other Resi (IO, SME)	30%	35%	45%	45%	55%	65%
Non Standard (No LMI)[#]	Refer proposed criteria	50%	60%	75%	100%	100%	100%
Non Standard (With LMI)[#]		35%	45%	55%	75%	75%	100%

Residential Mortgages HSBC PROPOSED_2 RW% - Standardised Approach							
LVR		≤ 60%	≤ 70%	≤ 80%	≤ 90%	≤ 100%	> 100%
		RW %					
Standard (No LMI)	OO and INV P&I	20%	25%	35%	45%	55%	75%
	Other Resi (IO, SME)	30%	35%	50%	65%	80%	85%
Standard (With LMI)	OO and INV P&I	20%	25%	35%	35%	40%	56%
	Other Resi (IO, SME)	30%	35%	50%	50%	60%	65%
Non Standard (No LMI)[#]	Refer proposed criteria	50%	60%	75%	100%	100%	100%
Non Standard (With LMI)[#]		35%	45%	55%	75%	75%	100%

We note the assumption that the risk classification is not permanent and any change in the underlying risk attribute will result in equivalent changes in risk categorisation. For example owner occupied interest-only at origination subsequently reverting to principal and interest will also revert from high to low risk category, and vice versa.

- Lenders Mortgage Insurance (LMI) - HSBC suggests APRA give consideration to LMI to provide similar concessions to the current approach for mortgages with LVR >80% for both standard and non-standard mortgages. Based on the local experience showing minimal loss for those mortgages with LMI cover, we recommend an approach would be to provide an RW reduction of 25% on equivalent RW% for mortgages without LMI at LVR >80% for both standard and non-standard mortgages. Additionally consideration could be given for increased RW% concessions to 50% where full LMI cover is provided vs those with a lower LMI coverage, minimum 40%.

- Non-standard RW – HSBC consider that RW 100% on "Non-standard" mortgages regardless of LVR position is difficult to justify with no capital incentives for secured lending and with equal treatment with unsecured retail lending. We observe that some

concessional RW would be sensible for non-standard loans particularly those with lower LVR and/or those with LMI. We suggest RW for non-standard mortgages to align with the current approach (refer above LVR/RW matrix).

- Security revaluation – HSBC seek clarification from APRA on whether APRA will adopt the BCBS requirement to retain the origination value for LVR purposes. We are concerned that this requirement will unnecessarily cause some churn out as mortgage holders are incentivised to re-mortgage in order to release capital built up as house prices increase or take benefit of more favourable pricing. Accordingly we believe it would be prudent to continue to allow some revaluations including short form revaluations subject to limitations such as maximum amount and high level of confidence restrictions, otherwise long form valuation by an accredited valuer.

- Fall-back treatment – HSBC recommend APRA to incorporate fall back for "non-standard" mortgages to revert back to "standard" if the customer has consistently met all payments as and when due over a consecutive 24 months period; or subsequent assessment evidences criteria causing "non-standard" treatment being cured. We propose a 2 year observation that is supported by evidence that probability of delinquency past the initial 2 years is greatly reduced and the origination assessment becomes less relevant.

Proposed Non-Standard Loans

- Overarching application – HBSC recommend that the assessment be conducted at the point of origination and subsequently if the applicant is refinancing or applying for additional loans. It would be punitive and unreasonable to apply criteria on existing loans from the time of implementation since serviceability and underwriting policies at the time may not have given consideration to those specific criteria nor priced accordingly for the higher risk categorisation.

  We note that any agreed criteria for non-standard loans such as NIS and DTI should be clearly and explicitly defined to ensure consistency of application amongst institutions. We support the application of additional criteria to identify non-standard loans from the point of origination post implementation date only.

  A non-standard loan assessed at origination could be re-categorised to standard at re-assessment (ie point of refinance or additional lending) and vice versa, or if the condition is met requiring a borrower to consistently make all contractual payments in full when due over a consecutive 24 months period.

- Approved outside serviceability policy – We note that the underlying reason for approval is typically due to temporary or transitional financial conditions mitigated by other financial factors and hence not necessarily a reflection of higher risk. Accordingly it seems reasonable to categorise loans approved outside the serviceability policy as high risk only if such loan fails specific criteria requirement such as negative NIS, high DTI, or non-application of IR floor or buffer.

  We advise that the dynamic nature of credit policies, diversity across institutions, what would be considered outside serviceability (ie minor waivers on verification requirements), peculiarity of some applications present practical challenges and consistency issues across institutions which makes it difficult to implement without some bias. Similarly there is an inter-link between individual criteria (ie negative NIS, non-application of IR floor/buffer, high DTI) and approval outside serviceability policy.

We believe the application of loan approval outside serviceability is too broad and it would be more pertinent and practical to narrow the test to specific and well defined criteria to avoid unnecessary overlaps and achieve consistency and avoidance of misguided behaviours towards policy changes.

- Negative NIS – We note the underlying reason for approval is typically due to temporary or transitional financial conditions mitigated by other financial factors. Typically this will be limited to bridging loan applicants.

  We suggest that the NIS status should be tested on a net basis at the origination point or at the time of refinancing or additional lending only. We believe it's not appropriate to perform the NIS test for standard/non-standard categorisation if the mortgage holder applies for a loan variation, hardship or becomes delinquent. We recommend that the measurement of NIS should be uniformly defined and consistently applied across institutions for an even and comparable test.

- No application of IR floor or buffer at assessment – We note the test is appropriate at the origination point or at the time of refinancing or additional lending only. Similar to the above point we believe it would not be appropriate to perform the test for standard/non-standard categorisation if the mortgage holder applies for a loan variation, hardship or becomes delinquent.

- High DTI – We suggest that a more comprehensive DTI measure is preferable to LTI subject to clearly defining a measure and setting an appropriate "high" benchmark. For consistency and comparative purposes we suggest DTI should be defined at gross pre-tax value to avoid the effect of policy variations across institutions.

  We believe the ongoing measurement of DTI may present challenges as the lending bank will have to maintain continuous monitoring for any new external debts (and payments of existing external debts) post origination, assuming local comprehensive credit reporting will be implemented across all institutions by the implementation date. Accordingly DTI test should be restricted to origination and refinancing points.

- Mortgage holders with multiple investment portfolio – We believe this measure should be based on a count of investment properties pledged (as opposed to a count of investment loans) in order to avoid an over count from instances like loan splitting.

  We suggest that a minimum threshold amount in conjunction with a threshold count of residential investment properties pledged, would avoid penalising investors with relatively smaller scale portfolio value, and/or a combined LVR threshold to exclude exposures with low leverage ratio or non-materially dependent on revenues from investment properties.

  A test is appropriate at the origination point or at the time of refinancing or additional lending only. We suggest that an ongoing assessment will present operational challenges, ie the bank may not be made aware of subsequent mortgages originated with other institutions, how to account for joint ownership, should debt free property owned be included in the assessment. We suggest that the mortgage holders with large portfolios of investment properties are likely to be highly leveraged and therefore this higher risk segment is likely to be captured under the High DTI measure. Accordingly we see minimal value in introducing this additional measure for non-standard loans if the High DTI assessment is the accepted test.

Other Exposures – Standardised Approach

- Exposure to corporate SMEs (unsecured) – We support the APRA proposal to reduce the current RW 100% to 85%, (although different to the Basel 75%), as it gives recognition to the variety of collateral provided by SMEs other than property.
- Unrated corporate exposures – Although contained within the final Basel III rules, the risk weight for unrated non-SME corporates (100%) under the ratings based version of the standardised approach is punitive and disproportionate to the risk. Banks in jurisdictions that do not allow the use of external ratings within the standardised approach are able to identify exposures that are investment grade and apply a risk weight lower than 100% (65%) to corporate exposures, even where that exposure is unrated. Given that the majority of corporate exposures are unrated, this will place banks using the rating based version of the standardised approach at a competitive disadvantage, as well as having a negative impact on the real economy. As a result, the rules should be amended so that, under the ratings based version of the standardised approach, banks are able to identify investment grade unrated corporates exposures and subject them to a reduced 65% risk weight.

- Other retail exposures (excluding credit cards) – We note that the APRA proposal to increase RW% on non-property secured retail exposures (exclusive of credit cards) from current 100% to 125% is in excess of the Basel minimum. We seek clarification if APRA has sourced evidence to support the assessment that Australian unsecured retail lending standards are less effective than in other jurisdictions to justify the proposed higher RW.

- Subordinated debt, equity and other capital instruments - We note the comments made in the discussion document that there will be further consultation on the risk-weighting of equity investments, venture capital and subordinated debt, presumably to clarify the circumstances in revised risk-weights included in the Table 30 on Page 63 would be applied.

  We welcome the opportunity for further discussion in this area, not least because we believe the Basel guidelines are deficient in some areas, particularly (a) the definition of venture capital which, as drafted, could capture a range of equity investments, such as growth capital investments, which should more properly attract a lower risk-weight and (b) the lack of any consideration of the effects of diversification in venture capital and equity investments, despite the proven benefits that this can have on portfolio risks.

The EU has held its initial consultation on the implementation of Basel 3 and HM Treasury's response specifically identifies this as an area for further consideration[1].

Credit Conversion Factor (CCF) on Undrawn

- HSBC is supportive of aligning CCFs between IRB and standardised approaches, however we note a material deviation from the Basel proposal should be supported by QIS outcomes and consideration of subsequent calibrations once revisions of trading book, credit valuation adjustments and sovereign exposures are finalised. Consistency in CCF application for contingent exposures between IRB and STA Banks will promote commercial alignment and fairer competition.

[1] https://www.gov.uk/government/publications/commission-consultation-on-basel-iii-implementation-hm-treasury-response

We believe that the proposed CCFs in excess of the Basel minimum may not promote international comparability and potentially create some distortion on other measures such as the leverage ratio. The proposed higher than Basel CCFs on undrawn commitments will have substantial implications on consumers and the wider economy.

We note that pricing will need to account for additional capital charges on undrawn balances which may cause consumer behaviour to either avoid overpayment and redirect excess funds to other investments or reduce their limits following overpayments. The disincentive for the customer to overpay their loan or keep some redraw headroom could potentially exacerbate their financial situation in instances of loss of income particularly in an economic downturn. The proposed higher CCFs will potentially reduce demand for credit and have an unfavourable consequences on the wider economic activity.

- CCF on undrawn credit cards – We believe the proposed higher CCF on undrawn Credit Cards than those proposed on unconditionally cancellable commitments is excessive.

  We note that a significant segment of unused credit card limits are made up of dormant accounts and/or to the higher credit quality customers and hence at the bottom of the probability of default. The majority of credit card holders pay either in full or a large proportion of their outstanding balance by the due date each month. Most consumers rely on such credit lines to provide them with some alternatives in their spending payments as opposed to revolving lines where the borrower routinely carries an outstanding balance on their account.

  We believe that applying a higher CCF 50% coupled with a RW 100% would penalize these low-risk revolving and transactor retail exposures and amplify the capital charge applying to Australian issuers of credit cards compared to those jurisdictions mandating the Basel minimum of CCF 10% and RW 75%. We note that Australian banks do proactively manage the risk with real time assessment that will enable immediate and unconditional cancellation of credit line when warranted. Similarly many card holders would have other secured credit commitments with the same institution such as a residential mortgage hence mitigating the risk of loss on revolving lines.

  It is acknowledged that losses on credit cards are more elevated than other credit commitments however after excluding fraud related losses there is no evidence that suggests credit card holders will typically draw on their cards in times of financial stress or use credit line as a liquidity source. The utilization rate appears to remain stable or decline as consumers reduce spending during difficult economic periods, and hence support a lower CCF than the proposed 50%.

  We would also suggest that RW 100% already adequately measures risks associated with both drawn and undrawn credit card balances without further increase in CCF above the Basel minimum of 10%. We are concerned that ultimately the higher proposed capital charge brought about by proposed higher CCF and above Basel RW% will lead to changes in the way commitments are written, activated and/or higher charges which will likely result in reduced credit limits available to consumers and downstream implication on consumption. An unintended consequence of higher CCF would place smaller and less mature credit card issuers at a competitive disadvantage. Multiple card holders will likely concentrate utilisation on their primary card held with one of the majors causing smaller card issuers to either offer additional incentives or increase pricing to cover higher capital charge.

- CCF on undrawn other commitments – We believe that the proposed CCF 100% for those not unconditionally cancellable is conservative and does not reflect the actual usage ratios of these credit lines and may adversely affect lending volumes and have a downstream impact on economic growth.

  We note that pricing will account for additional capital charges on undrawn balances and likely cause borrower behaviour to either avoid overpayment and redirect excess funds to other investments or reduce their limits following overpayments. The disincentive for the customer to overpay their loan or keep some redraw headroom could potentially exacerbate their financial situation in instances of loss of income particularly in an economic downturn.

  We believe that the proposed CCF 100% on non-cancellable commitments is overly conservative and presumes certainty of drawdown in all instances which is far from the actual experience on non-cancellable credit facilities. The implications of such severe treatment on corporate borrowings will likely be to minimise borrowing cost by reducing size of borrowings and/or agree to shift their facilities to cancellable limits. This will have significant detriment on corporate ability to prudently manage their liquidity and longer term funding as well as restrict their capacity to fund new investments. An unintended consequence of proposed CCF 100% on non-cancellable corporate commitments is potentially penalise locally incorporated international banks who proportionally have a higher concentration to term loans and minimal business banking representation. The larger majors will gain a significant competitive advantage as a result of diversification a mix in their loan portfolio.

  We would support a CCF alignment consistent with Basel (CCF 40%) unless local context dictates tangible reasons for the higher CCF.

The Basel package contains a national discretion to exempt certain arrangements from the definition of commitment provided that the bank received no fee or commission, the client is required to apply to the bank for drawdown, the bank has authority over the execution of the drawdown, and the decision is made after a credit assessment has been made. The discussion paper is silent on whether this national discretion will be exercised; however we consider it appropriate that it should be since such facilities are within the control of the lender and therefore do not represent an exposure.

Operational Risk

- We note that APRA proposes to set the internal loss multiplier to 1 under the new operational risk regime but that APRA reserves the right to make adjustments to the charge where it lacks credibility for a particular bank, for example due to its loss history. We would ask that, in addition, APRA commit to reviewing regularly its decision to set the loss multiplier to 1 at an overall jurisdiction level to consider whether the aggregate loss history would render setting the loss multiplier to 1 as punitive.

Conclusion

The proposed implementation date of January 2021 does not give consideration to liquidity implications resulting from capital reforms. We recommend APRA delay implementation date to match BCBS so as to allow assessment of liquidity implications and other elements of capital framework that are yet to be consulted on.

It is important to achieve a balanced outcome to the capital framework without seeking overly conservative standards that would promote financial stability, local and global competition, and prudent lending policies and practices. There are a number of areas in which APRA is proposing standardised risk-weights which are higher than those proposed by the Basel Committee. We appreciate that APRA may have concerns about the relative risks of certain sectors in the Australian financial system but we have two observations about the potential consequences which arise from setting higher risk-weights in the regulatory framework:

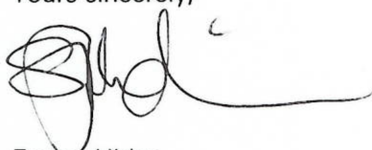
(a) This may mean that the comparative strength of Australian banks in terms of like-for-like capital ratios is less obvious to equity and debt investors, particularly those which operate in international capital markets.

(b) Establishing structurally super-equivalent risk weights reduces the ability for APRA to vary risk-weights on a macro-prudential basis if it becomes apparent that the circumstances giving rise to these risks were cyclical, rather than structural.

Adopting Basel risk-weights, with a macro-prudential buffer which may be varied through time, could be another way of approaching these sectors.

We thank APRA for considering our comments and should you have any questions, please do not hesitate to contact our Regulatory Affairs team via email regulatoryaffairs.au@hsbc.com.au.

Yours sincerely,



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