August 5, 2021

Mr. Michael Roberts
President & Chief Executive Officer
HSBC North America Holdings, Inc.
452 Fifth Avenue, 5th Floor
New York, NY 10018

Subject: Response to request for reconsideration of the stress capital buffer requirement, pursuant to the Board's capital plan rule

Dear Mr. Roberts:

This letter is in response to the request by HSBC North America Holdings, Inc. ("HNAH"), for reconsideration of the stress capital buffer requirement provided to HNAH by the Board on June 24, 2021. For the reasons stated below, the Board has affirmed the stress capital buffer requirement previously provided to HNAH. In addition, with respect to the request by HNAH for an informal hearing in connection with the request for reconsideration, the Board has not ordered an informal hearing.

I. Background

The Board's capital plan rule[1] establishes the Board's process for determining the stress capital buffer requirement applicable to a firm subject to the capital plan rule. Pursuant to that rule, the Board generally will provide a firm with notice of its stress capital buffer requirement by June 30 of each year in which the firm submits an annual capital plan.[2] On June 24, 2021, the Board provided HNAH with notice that its stress

[1] 12 CFR 225.8.

[2] 12 CFR 225.8(h)(1).

capital buffer requirement associated with its 2021 annual capital plan submission is 7.5 percent.[3]

The capital plan rule permits a firm to request reconsideration of the stress capital buffer requirement within 15 calendar days of receiving notice of the requirement.[4] HNAH requested reconsideration of its stress capital buffer requirement on July 6, 2021. A request for reconsideration may include a request for an informal hearing on the firm's request for reconsideration.[5] HNAH's request for reconsideration included a request for an informal hearing. The capital plan rule generally provides that the Board will notify a firm of the Board's decision to affirm or modify the firm's stress capital buffer requirement within 30 calendar days of receipt of the firm's request for reconsideration, or within 30 days of the conclusion of an informal hearing regarding such a request.[6]

In each year in which a firm submits an annual capital plan, the Board generally will provide the firm with a final stress capital buffer requirement, as well as confirmation of the firm's final planned capital distributions for that year, by August 31.[7] Unless otherwise determined by the Board, the final planned capital distributions and final stress capital buffer requirement for a given year become effective October 1 of that year.[8] A stress capital buffer requirement that becomes effective will remain effective until superseded.[9]

II. Stress Testing Framework

The stress capital buffer requirement is established based, in part, on the results of a supervisory stress test conducted by the Board. Specifically, a firm's stress capital buffer requirement is the greater of 2.5 percent or the following calculation: (1) the difference between the firm's starting and minimum projected common equity tier 1 (CET1) capital ratios under the severely adverse scenario in the Board's supervisory stress test plus (2) the sum of the dollar amount of the firm's planned common stock

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[3] See email regarding 2021 Stress Test Results (June 24, 2021).

[4] 12 CFR 225.8(h)(2)(i) and (i)(2).

[5] 12 CFR 225.8(i)(3)(ii).

[6] 12 CFR 225.8(i)(5).

[7] 12 CFR 225.8(h)(4)(i).

[8] 12 CFR 225.8(h)(4)(ii)(A).

[9] 12 CFR 225.8(h)(4)(ii)(B).

dividends for each of the fourth through seventh quarters of the planning horizon[10] as a percentage of risk-weighted assets.[11] The stress capital buffer requirement provided to HNAH on June 24, 2021, was calculated based on 2021 supervisory stress test results released by the Board.[12]

The results of the Board's supervisory stress tests are projected using a set of models developed or selected by the Federal Reserve that take as inputs (1) the supervisory scenarios created by the Federal Reserve and (2) firm-provided data on the firm's financial condition and risk characteristics. To provide firms and the public with

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[10] The planning horizon is the period of at least nine consecutive quarters over which the relevant projections extend, beginning with the quarter preceding the quarter in which the firm submits its capital plan.

[11] 12 CFR 225.8(f)(2).

[12] See Board of Governors of the Federal Reserve System, *Dodd-Frank Act Stress Test 2021: Supervisory Stress Test Results* (June 2021), available at https://www.federalreserve.gov/publications/files/2021-dfast-results-20210624.pdf. On February 5, 2019, the Board released materials intended to increase the transparency of the stress testing program. See https://www.federalreserve.gov/newsevents/pressreleases/bcreg20190205a.htm. First, the Board updated the Policy Statement on the Scenario Design Framework for Stress Testing ("Scenario Policy Statement") to provide additional information regarding the path of home price variables, in particular, reducing uncertainty about the path of these variables in the severely adverse scenario. See 12 CFR part 252, Appendix A. Second, the Board adopted a final Stress Testing Policy Statement to provide additional information about the Board's principles and policies with regard to the development and validation of supervisory stress test models. See 12 CFR part 252, Appendix B. As described in the Stress Testing Policy Statement, material changes to the supervisory stress test models are phased in over two years to reduce year-over-year volatility stemming from updates to the supervisory models. The Stress Testing Policy Statement defines a model change as highly material if its use results in a change in the CET1 ratio of 50 basis points or more for one or more firms, relative to the model used in prior years' supervisory exercises. See 12 CFR part 252, Appendix B, at 2.3. This approach contributes to the stability of the results of the supervisory stress test by ensuring that changes in model projections primarily reflect changes in underlying risk factors and scenarios, year over year. Third, the Board provided additional information about the models used in the supervisory stress test. See 84 Fed. Reg. 6784 (Feb. 28, 2019). The Board is committed to continuing to provide additional information, including modeled loss rates by loan and borrower characteristics, about its stress test models, as it has done most recently for its corporate loan and credit card models.

greater transparency regarding the Board's process for designing supervisory scenarios for stress testing, the Board first finalized the Scenario Policy Statement in 2013.

Consistent with the principles described in the Stress Testing Policy Statement, the Federal Reserve designed the system of models so they would result in projections that are (1) from an independent supervisory perspective; (2) forward-looking; (3) consistent and comparable across covered companies; (4) generated from simple approaches, where appropriate; (5) robust and stable; (6) conservative; and (7) able to capture the effect of economic stress.[13]

The Federal Reserve's models rely on detailed portfolio data provided by firms but generally do not rely on models or estimates provided by firms, consistent with the modeling principle that emphasizes an independent perspective.

The Federal Reserve generally develops its models under an industry-level approach that is calibrated using data from many financial institutions. This approach reflects modeling principles that favor models resulting in consistent, comparable, and forward-looking projections. The Federal Reserve models the response of specific portfolios and instruments to variations in macroeconomic and financial-scenario variables such that differences across firms are driven by differences in firm-specific input data, as opposed to differences in model parameters and specifications. As a result, two firms with the same portfolio receive the same results for that portfolio in the supervisory stress test, facilitating the comparability of results. In addition, the industry-level approach promotes a forward-looking stress test, as it results in models that do not assume that historical patterns will necessarily continue into the future for individual firms. These policies also help to ensure that consistent and comparable supervisory models are forward-looking, robust, and stable.[14]

[13] 12 CFR part 252, Appendix B, at 1.

[14] While the Federal Reserve limits the use of firm-specific fixed effects and the use of dummy variables indicating a loan vintage or specific year, it makes exceptions where appropriate. For example, the Federal Reserve may use firm-specific indicator variables, firm-provided estimates, or third-party models or data in instances in which it is not possible or appropriate to create a supervisory model for use in the stress test, including when supervisory data are insufficient to support an independently modeled estimate of losses or revenues. However, the Federal Reserve does not adjust supervisory projections for individual firms or implement firm-specific overlays in the supervisory stress test. This policy ensures that the supervisory stress test results are determined solely by

III. Discussion

As required by the Board's capital plan rule, HNAH's request for reconsideration of its stress capital buffer requirement included a detailed explanation of why it contends that reconsideration should be granted.[15]

To ensure that review of HNAH's request would be conducted with an independent perspective, a group of experts within the Federal Reserve System, who are independent of the staff who developed the models, analyzed the arguments made by HNAH in favor of reconsideration of its stress capital buffer requirement.[16] With respect to each of the issues raised in the request of HNAH, the experts considered whether the request pointed to any errors in the firm's stress test results and whether each stress test model identified in the firm's request is operating as intended, within the bounds of the Board's published policies. The information in this letter regarding the Board's stress testing policies and supervisory modeling practices was previously publicly disclosed, consistent with the Board's practice to increase the transparency of the stress testing program.[17]

In its request, HNAH argues that the Federal Reserve's models overstated commercial real estate ("CRE") losses under the stress test conditions, which HNAH asserts materially increased the firm's stress capital buffer requirement. Specifically, HNAH argues that (1) the Federal Reserve's models inflated the risk of its CRE portfolio, resulting in a heightened CRE loss rate; (2) the projected CRE loss rate is procyclical, whereas a through-the-cycle loss rate should have been used; and (3) the proposed stress

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supervisory models and firm-specific input data. The Federal Reserve has instituted a policy of not using additional input data submitted by one or more of the covered companies unless comparable data can be collected from all the firms that have material exposure in a given area.

[15] See 12 CFR 225.8(i)(3)(i).

[16] This group is composed of staff members from across the Federal Reserve System who are subject-matter experts and are not involved in supervisory modeling. This group's model validation process includes reviews of model performance; conceptual soundness; and the processes, procedures, and controls used in model development, implementation, and the production of results. See Board of Governors of the Federal Reserve System, *Dodd-Frank Act Stress Test 2021: Supervisory Stress Test Methodology* at 5–6 (April 2021), available at https://www.federalreserve.gov/publications/files/2021-april-supervisory-stress-test-methodology.pdf.

[17] See supra note 12.

capital buffer requirement does not reflect [redacted] reductions in CRE exposures. With respect to each of these arguments, the Board has assessed HNAH's stress test results and the Federal Reserve's models for errors. Through this assessment, the Board did not identify any errors in HNAH's stress test results and has determined that the models operated as intended, within the bounds of the Board's published policies.

As discussed above, HNAH's request for reconsideration included a request for an informal hearing. The Board has determined not to grant HNAH's request for an informal hearing regarding its request for reconsideration.[18] The informal hearing process is intended to ensure that a firm is able to present its arguments to the Federal Reserve and to provide an opportunity for both the firm and the Federal Reserve to ask any questions regarding the request, including questions regarding disputed issues of material fact. Since the submission of HNAH's request, Federal Reserve staff has met with representatives from HNAH. The firm described its arguments for reconsideration in these meetings, and both the firm and Federal Reserve staff had the opportunity to ask questions. Federal Reserve staff also offered to hold additional meetings. In light of this process, the Board does not believe it is necessary to order an informal hearing regarding HNAH's request.

1. *CRE Portfolio Risk*

HNAH asserts that the Federal Reserve's models do not appropriately reflect the characteristics of the firm's CRE portfolio, and consequently overstate the portfolio's risk. The Board investigated the firm's assertion and determined that the CRE model, as adjusted in light of the COVID event, operated as intended, within the bounds of the Board's published policies.[19] The CRE model projects loan losses based on specific

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[18] See 12 CFR 225.8(i)(4)(i) (providing that the Board has sole discretion regarding whether to order an informal hearing).

[19] The Federal Reserve's approach to modeling losses on CRE portfolios in its stress test is detailed in its supervisory stress test methodology disclosure. See *Dodd-Frank Act Stress Test 2021: Supervisory Stress Test Methodology*, supra note 16, at 16, 27–29. As it had done in the December 2020 stress test, the Federal Reserve made a targeted adjustment to its CRE loss model for the 2021 supervisory stress test in light of the disruption caused by the COVID event, which set a lower bound on collateral recovery rates for loans backed by hotel properties. See *Dodd-Frank Act Stress Test 2021: Supervisory Stress Test Results*, supra note 12, at 19–20. This adjustment had the effect of reducing the sensitivity of the model to specific portfolio factors.

portfolio characteristics (for example, property type, geography, maturity, and loan-to-value ratio). The Board's investigation concluded that the composition of the firm's CRE portfolio accounts for its relatively high projected loss rate. The model is consistent with the Board's published methodology disclosures and is in line with the Stress Testing Policy Statement's principles of consistency and comparability, simplicity, and adoption of industry-level projections.[20] The Board has determined that it will follow its published principles for stress testing with regard to the projection of CRE losses.

2. *Procyclicality, Volatility, and Transparency*

HNAH asserts that the increase in its stress capital buffer requirement and projected CRE loss rate amounts to procyclical regulation that produces a volatile capital framework. The Federal Reserve takes these policy concerns seriously, given their implications for the performance of the capital framework. The Board has implemented policies designed to mitigate volatility and avoid adding procyclicality to the stress testing framework.[21] In addition, the Board continues to consider additional policies to mitigate stress test volatility. The concerns raised by HNAH do not reflect errors or issues with the modeling approach that would warrant reconsideration.

3. *Incorporation of Changes in CRE Exposures*

HNAH requests that the Board take account of the [redacted] reductions to the CRE exposures in reconsidering its stress capital buffer requirement. The Federal Reserve generally bases the final stress test results on data filed by established regulatory reporting deadlines and projects that a firm takes actions to maintain its current level of assets over the projection horizon. These practices, in part, contribute to consistency and comparability across firms and are consistent with the Policy Statement.[22] With respect to this request, the Federal Reserve will follow its stated methodology of declining to make firm-specific assumptions regarding balance

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[20] See 12 CFR part 252, Appendix B, at 1.3, 1.4, and 2.4; *Dodd-Frank Act Stress Test 2021: Supervisory Stress Test Methodology*, supra note 16, at 16.

[21] For example, the principles of simplicity and comparability and a policy of gradual phase-in of material model changes are explicitly intended to reduce volatility and improve transparency. The methodology for specifying the stress scenarios is designed to avoid adding procyclicality to the financial system. 12 CFR part 252, Appendices A and B.

[22] See *Dodd-Frank Act Stress Test 2021: Supervisory Stress Test Methodology*, supra note 16, at 7, 14.

sheet trends. Further, given the Federal Reserve's standard practice of basing stress test results on the data filed by the relevant reporting deadline, it will not consider changes to HNAH's CRE portfolio made after December 31, 2020.

IV. Conclusion

After consideration of the Board's stress testing policies and all relevant facts, including the information provided in the request, and consistent with the Board's regulations, the Board has determined to affirm the stress capital buffer requirement provided to HNAH on June 24, 2021. The Board notes that it is focused on continuously improving the stress testing framework, including the Board's supervisory models. With regard to the arguments raised by HNAH in the request for reconsideration, the Board has directed Federal Reserve staff to investigate and address, as appropriate, the risk sensitivity of the commercial real estate model to see if any future improvements can be made. In evaluating any of its supervisory models, the Board follows the processes for development, implementation, and validation of its supervisory models, as outlined in the Board's Stress Testing Policy Statement.

The final stress capital buffer requirement for HNAH is 7.5 percent. The Board hereby confirms that the planned capital distributions HNAH submitted as part of its 2021 capital plan submitted on April 5, incorporating any adjustments made pursuant to 12 CFR 225.8(h)(2), are final. HNAH's final stress capital buffer requirement and final planned capital distributions are effective October 1, 2021. The Federal Reserve supports banking organizations that choose to use their capital buffers to lend and undertake other supportive actions in a safe and sound manner.[23] When using their buffers, banking organizations may make capital distributions up to prescribed limits, which include automatic limitations in the capital framework, as well as any additional limitations determined by the Board.[24]

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[23] See Interagency Statement on the Use of Capital and Liquidity Buffers (March 17, 2020), available at https://www.federalreserve.gov/newsevents/pressreleases/bcreg20200317a.htm.

[24] A "capital buffer" refers to capital held above regulatory minimum requirements. Banking organizations with regulatory capital ratios that are below their capital buffer requirement face gradual restrictions on capital distributions and discretionary bonus payments. See 12 CFR 217.11(c). These restrictions encourage banking organizations to conserve capital within the organization as they lend to households and businesses and as their capital levels approach minimum regulatory

Please contact Julie Anthony at (202) 475-6682 with any questions.

Sincerely yours,

(Signed) Ann E. Misback

Ann E. Misback
Secretary of the Board

cc: Jacki Hitchings, Assistant Vice President
Federal Reserve Bank of Chicago

capital requirements. Capital buffers were designed to provide banking organizations with the means to support the economy in adverse situations and to allow banking organizations to continue to serve households and businesses.