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By e-mail : cp20@c-ebs.org

Brussels, 05/11/2008,

Technical aspects of diversification under Pillar 2

Dear Mrs af Jochnick,

Febelfin, i.e. the Federation which regroups four trade associations from the Belgian financial industry¹, welcomes the opportunity to express its views on the consultation paper mentioned above.

We welcome the guidance provided for in CP 20 and consider it as a first positive step towards a better understanding of banks' economic capital. However, we regret the demand to integrate some margins of conservatism when calculating economic capital. This approach may lead to a total loss of diversification effects, reducing the issue to a purely theoretical concept.

Furthermore, we regret that the CEBS-document is, in contrast to the consultative Basel document "*Range of practices and issues in economic capital modeling*", too much orientated towards qualitative aspects (such as documentation and governance) instead of the quantitative aspects of diversification. In this regard, we deplore that the document does not make the essential difference between intra and inter risk diversification. Neither is attention given to the absence of benchmarks


¹ The following trade associations are part of Febelfin: the Belgian Bankers' and Stockbroking Firms' Association (ABB/BVB); the Professional Association of Credit Providers (UPC/BVK); the Belgian Association of Asset Managers (BEAMA); the Belgian Leasing Association (BLA).

for stress testing of diversification effects. This reduces the application of these specific guidelines to a large extent. More importantly, we advocate that attention could be given to apportionment methodologies when calculating economic capital on consolidated level.

Last but not least we advocate a reality check of many guidelines as many of them are seen as too prescriptive and in some cases even impossible to implement.

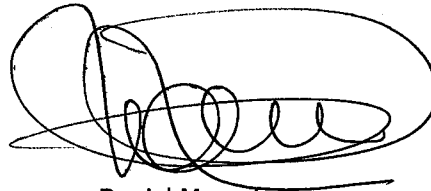
We hope our remarks can be taken into account. Please feel free to contact us, if you want further information and comment.

Yours sincerely,



Michel Vermaerke

Chief Executive Officer



Daniel Mareels

Director Taxation and Prudential,

Legal and Compliance

Enc.

Cc : Mr J.-P. Servais, Chairman of the Banking, Finance and Insurance Commission

Consultation paper on technical aspects of diversification under Pillar 2, Febelfin comment

General Comments

- In general, we welcome the guidance of CEBS on the possible recognition of diversification under Pillar 2. This is a **first positive step** towards better understandings of banks' economic capital. In this respect, we are also supportive of the CEBS initiative of joint EU examination team on some SON cross-border banks economical capital framework. We believe this will lead to further understandings amongst supervisors, and increase market best practices.
- However, we find the annexed list with regulatory questions **too prescriptive** in a field which belongs to the own process of the institution.
- The CEBS CP 20 is presented as a document on the "technical aspects of diversification", while it deals with a much larger scope since it tackles issues related to the ICAAP in general such as internal governance, pillar 1/ pillar 2 reconciliation, models developments, and group supervision issues. It should be noted that the consultative Basel document "*Range of practices and issues in economic capital modeling*" has its **focus on the technical aspects**, which is to be **preferred**.
- CEBS guidelines as expressed in the consultation paper are seen as a "wish list", i.e. stating principles which seem to be self-explanatory, but which are in practice very prescriptive and for many of them impossible to implement. **A reality check should be done** with current market practices.
- All the **guidelines are constraining and demanding regarding the analysis process** proposed. We advocate that recognition of part/total diversification should not become conditional to the fulfillment of the various requirements expressed in this paper.
- Definition of diversification: General diversification can be broadly decomposed into **intra and inter diversification**. Intra diversification is most of time accounted for directly within Risk Type capital models whereas Inter diversification results from the aggregation of the different risks. In the CEBS document, no distinction is made between the two forms of diversification whereas, we believe that they require separate treatments regarding the correlation estimations as well as the approach used to materialize these forms of diversification.
- **Qualitative versus quantitative approach**: We believe that the document is too much orientated on governance and the qualitative requirements. Instead, we prefer more guidance on the quantitative aspects of intra and inter diversification. As an example we refer here to the consultative Basel document "*Range of practices and issues in economic capital modeling*".

- **Documentation:** there is a strong focus on documentation of every step of the diversification process (intra and inter). Even if we recognize the added value of having a clear documented process and framework, the requirements on documentation as expressed in the consultation paper are really ambitious, and can lead to a very burdensome process. In addition, documentation should not be the condition to recognize diversification.
- The document assumes that there exists already a benchmark on **stress testing** for measuring diversification effects. This is not the case, hence the application of these specific guidelines seems rather theoretical.
- **Bank's economic approach:** in different instances, CEBS outlines the necessity for economic capital to integrate some margins of conservatism. This approach is in contradiction with the mere objective of banks' economic capital of being accurate and reflecting the economical view, and not the regulatory view. We also note that this conservative approach may lead for institutions to a total loss of diversification effects, reducing the issue to a purely theoretical concept.
- **Scope of application:** according to the Capital Requirements Directive, an economic capital has to be calculated, in the context of pillar 2 requirements, for each legal entity. The paper mentions the group supervision issues, but does not tackle the different apportionment methodologies. This is questionable that such an important and difficult issue is not mentioned in these "technical" guidelines.
- **Common European approach:** we prefer a common European and international approach in this area. Therefore it would be welcomed if all European regulators could find a common position on this topic.

Comments by Sections

i) general overview of capital/diversification model

1.1 Methodology and documentation

High documentation standards are set. Even if logical, that should not become too burdening and should not condition the recognition of diversification. (Recommendation 11., 14. and 15.) Recommendation 12. tries to establish the link with Pillar 1 Risks intra-diversification as a constraint even if the context of the paper is Pillar 2 where we promote an economical view .

1.2 Scope

The document insists on the completeness of the various risk factors that should be considered within capital framework. Even if that can impact the estimation of correlation, this is a pre-requisite of capital models that are out of the scope of this analysis. (Recommendation 2.). In the same context, the document does not question problems linked to Time Horizon and Confidence Interval discrepancies when aggregating risks.

1.3 Model structure and parameter estimation

Really few is said about the various ways of aggregating risk types (inter risk) contrary to the consultative Basel document “*Range of practices and issues in economic capital modeling*” where extensive analysis are performed on the various alternatives (Recommendation 20.).

ii) *diversification parameters*

2.2 Correlations

Again, no distinction is made between Intra and Inter diversification/correlations. We know that Intra diversification is most of the time far more important than Inter diversification.

2.3 Third party parameters and data

The document questions the use of third party data especially in terms of reliability and representativeness. It should be stressed here that in most cases, that information is only available for Inter Risk correlations as no history is externally/internally available to benchmark/estimate dependency structure between risks in a +/- reliable way (knowing that statistical approaches will be subject to potentially important inference errors). Again, the absence of clear separation of Inter/Intra diversification is questionable.

3.1 Robustness, stability and conservatism

Conservatism is presented as one of the key issues of interest to supervisors when looking into capital models. It is however contradictory with the Economic Capital philosophy where accuracy and economic view are the main concepts.(Recommendation 52.)

The document states that the estimation process should reflect current and foreseeable market conditions and provide forward-looking estimates of the diversification benefits, resulting in prompt reaction to sudden changes in the economic cycle. This is a quite challenging assumption as it is not even possible to forecast at a 3-month horizon.

The document draws attention on the assumption of stability of correlation parameters over time. Again, a distinction should be made between Intra and Inter diversification where the latter should show more stability and the former be more reactive to idiosyncratic and systemic factors.

3.2 Stress-testing

We refer to our general comment on stress testing mentioned above.

3.3 Sensitivity analysis

iii) *internal model validation*

It is not related as such to diversification in the Economic capital framework

5.1 Governance

It is not related as such to diversification in the Economic capital framework

5.2 Decision-making process and reporting

It is not related as such to diversification in the Economic capital framework

vi) *understanding the differences between Pillar 1 and Pillar 2 results*

We recognize the necessity to carry a pillar 1/ pillar 2 reconciliation in order to understand the differences between regulatory capital and economic capital