



29 September 2008

Public hearing on CEBS' Consultation paper on technical aspects of diversification under Pillar 2 (CP20)

Note of meeting

London, 8 September 2008

The Chair of the CEBS working group dealing with technical aspects of Pillar 2 – Pillar 2 Convergence Network (P2CN) - presented the current work being undertaken by CEBS on Pillar 2 issues, and outlined the tentative medium-term work programme for the Network. Currently, CEBS is working on various Pillar 2 topics: liquidity risk and its management; some cross-border aspects including scope of application, reporting frequencies and remittance dates; and technical aspects of risk diversification and concentrations. The work on all these topics is allocated between various CEBS expert groups.

In the presentation of the Consultation paper on technical aspects of diversification (CP20), the Chair of P2CN concentrated on explaining the general nature of the document, pointing out particularly that its contents were intended for supervisors rather than institutions – it to be a useful operational tool supporting ICAAP-SREP dialogue and not a set of guidelines. CP20 focuses on diversification effects arising within those parts of economic capital models that are used for ICAAP purposes and is expected to provide support to supervisors in their SREP assessments. The principles laid down in CP20 should not be seen as cutting across the central tenet of Pillar 2 – that firms have ownership of their internal capital models and other ICAAP processes.

The document provides an overview of the areas of potential supervisory interest with respect to diversification arising from ECMs used for ICAAP purposes. It provides a background and basis for evaluation of diversification effects rather than guidance on which (if any) should be accepted. Therefore the emphasis is on supervisory understanding of firms' internal capital modelling (economic capital modelling) and on the general qualitative controls over such modelling, including the environment in which the modelling takes place. Respecting firms' ownership of internal capital models and the wide range of approaches to modelling economic capital and diversification, the paper has rather limited

coverage of different quantitative approaches and is silent on anticipated capital levels arising from model outputs.

After the presentation, participants were asked to provide first their general comments, and then specific comments relating to each individual section of the CP20. The main questions and comments are briefly summarised below:

- Participants requested more clarity of the nature and the focus of the document (were these recommendations to supervisors or firms, and was the coverage diversification only or wider aspects of internal/economic capital modelling) and asked for a section to include definitions of terms used in the document, including diversification, internal capital etc. They suggested that technical terminology used in the document should be further reviewed as there was some ambiguity in the use of certain terms (e.g. correlation parameters are not the same as diversification parameters as the diversification concept is much wider, and risk appetite and changes in business strategy cannot be directly reflected in correlation parameters).
- The focus on recommendations for supervisors in the document could be more explicit in the wording of the whole document, as some paragraphs in the current version were somewhat prescriptive and could be read as guidelines to firms.
- Whilst addressing wide issues of internal capital and diversification modelling both in the main body and including in the annex sections on internal validation, stress testing, internal governance, use test etc. CEBS should consider providing some indications of the relative priorities of one or another section.
- A number of participants asked for more clarity on how to address conservatism in the models (changing parameters, outputs etc.) without compromising accuracy. The view was that these two notions were somewhat contradictory and hard to achieve simultaneously, and the paper could be more precise about what supervisors should expect.
- Even though the direct focus of the paper was diversification, it dealt also with wider issues of economic capital modelling and general ICAAP principles, which in the later case were already addressed by other CEBS Guidelines (Pillar 2 Guidelines – GL03). CEBS was asked to check the consistency with other guidelines to ensure appropriate cross-referring, and to consider dropping the general ICAAP principles from the CP20. The same issue arises with the principles of internal governance and senior management involvement in internal capital models (they should have an adequate understand of how the model works and what its key strengths/weaknesses were, but would not necessarily be expected to know the technical details) as well with supervisor expectations for internal

validations. The text of the document could be more aligned with the final text of the CEBS Guidelines on Pillar 1 model validations (GL10).

- Expectations that firms would always be able to provide complete documentation of all historical changes to model could be over-ambitious and unreasonable, especially in the case of model with a development history going back for more than 10 years. The same was also true with respect to requiring the model to cover “all” risks, as this is too ambitious and hard to achieve: the model should cover all “known and material risks”.
- A number of the participants questioned the proposed benchmark for comparing diversified economic capital numbers (Pillar 2 capital numbers) with undiversified Pillar 1 capital numbers. Although it is widely understood that supervisors tend to compare the two numbers, since Pillar 1 requirements constitute the actual or practical reference, the participants pointed out that the differences between Pillar 1 and Pillar 2 are not explained only by diversification but by numerous other factors, e.g. different confidence levels, wider/narrower scope of risks covered etc. A more appropriate benchmark could be to use an undiversified economic capital measure, but it might also be misleading and difficult to compute (relatively easy to “switch off” inter-risk diversification components, but not intra-risk diversification as in most cases it is embedded into the modelling of each particular risk type).
- The application of the stress testing regime to economic capital models should be clarified, as by its design most of the models already involve use of multiple scenarios, which means that stress testing is directly embedded into the modelling process. Furthermore economic capital models are generally based on confidence levels higher than the ones used for Pillar 1 purposes. Therefore the application of additional stress tests to already “stress tested” results of the model might be misleading.
- Expectations on back-testing are unreasonably high, as back-testing of the tail part of the distribution created at the e.g. 99.97% confidence level is hard to achieve without centuries of data.
- Some participants also questioned the relevance and need for Section 7 on “Group dimension” to be included in what is otherwise a technical document. The section as it is currently drafted does not provide much information, but only raises questions. Participants also pointed out that ICAAP and economic capital model may not work other than on a consolidated perspective since calculations are done only at group level and there a stand-alone economic capital at entity level would not be able to factor in group diversification. They requested the group to consider undertaking a further elaboration of the group dimension, and of the cross-border application of economic capital and the ICAAP.

Participants to the hearing were encouraged to send their written comments to the CP20 by 31 October 2008. All comments received will be published on CEBS' website unless respondents explicitly request otherwise. The revised version of the document, based on the results of the public consultation, is expected to be ready by the end of 2008 and will be published on the CEBS website (supplemented by a press release).

List of participants

1.	Nick Lock	Chair of the P2CN	
2.	Oleg Shmeljov	CEBS Secretariat	
3.	Wilfried Wilms	European Banking Federation	Belgium
4.	Sebatien Rerolle	BNP Paribas	France
5.	Sylvain Cuenot	Comission Bancaire	France
6.	Said Bouaziz	Dexia	France
7.	Uwe Ghumert	Association of German Banks	Germany
8.	Andreas Grob	Bundesverband Deutscher Volksbanken	Germany
9.	Wilfried Paus	Deutsche Banks	Germany
10.	Silvio Andrae	German Savings Banks Association	Germany
11.	Valerio Novembere	IMT Lucca	Italy
12.	Jurgen Willemsen	De Nederlandsche Bank	Netherlands
13.	Pieter Schermers	ING Goup	Netherlands
14.	Jose Manuel Desviat Manzanares	Banco Santander	Spain
15.	Charlotte Elsnitz	Swedbank	Sweden
16.	Timothy Buenker	British Bankers Association	UK
17.	Peter Elstob	Complinet	UK
18.	Simon Fish	HSBC Holdings plc	UK
19.	Penny Deng	HSBC Holdings plc	UK
20.	Louisa Waite	Financial Services Authority	UK
21.	John Thorp	Financial Services Authority	UK
22.	Ton Vorst	Royal Bank of Scotland	UK