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Consultation paper "CEBS Guidelines on Aspects of the Management of Concentration Risk under the Supervisory Review Process" (CP 31)

Dear Sir or Madam,

On 11 December 2009, CEBS published a consultation paper entitled "Guidelines on Aspects of the Management of Concentration Risk under the Supervisory Review Process". We have pleasure in taking the opportunity to comment on it.

General observations

The distinction made in point 6 between intra-risk and inter-risk is in no way artificial, but results from the actual evolution in the financial sector. Traditionally, risk assessment models were established to start with within individual risk types, which in the meantime have become very highly developed. We agree that interactions between positions in different risk types must also be described. However, theoretical model approaches do not present any comparable industry standard here; on the contrary, the practical application is still in its infancy.

For many institutions, the analysis of concentration risk across risk types must primarily take place in the context of the stress testing or scenario analyses. The requirement concerning a fully integrated approach to the measurement and control of concentration risks – as implicitly called for in CP 31 – leads to considerable expenditure without any corresponding benefit. Moreover, we point out the model risk inherent in the inter-risk integration approaches.

In this connection, it is already discernable from the wording of the consultation paper that, in the case of concentration risks, it is not a matter of a specific type of risk, but rather of risk concentrations which may result from positions within a risk type and also from potential interactions between positions in different original risk types. In our opinion, considering possible effects of these interactions between these positions from a business point of view represents a challenge for the institution.

It is to be welcomed that, according to point 11, for small and medium-sized and less complex institutions, the management of risk concentrations can be confined to credit portfolios. However, in our opinion, CEBS wrongly emphasises that regional and specialised credit institutions present concentration risk per se and have to be especially careful in dealing with it. In particular against the backdrop of the principle of proportionality enshrined in point 11, CEBS should refer to the importance of knowledge of the local market and specialised expertise of these institutions as risk-mitigating factors.

The proposed amendments in part entail a comprehensive need for adaptation in the institutions. This relates in particular to the IT conversion. In our opinion, it should be clarified that the deadline mentioned of 31 December 2010 refers to the strived-for time of transposition in the respective national legislation and not to the implementation of the new rules in the respective banks.

The implementation study mentioned in point 13 is ambiguous. We would ask for a brief description of which activities are to be understood by this.

General considerations and principles for concentration risk management

Point 27 requires institutions to correctly price risks. At the same time, in this connection, a forward-looking approach to concentration risk management on the basis of potential evolutions in the environment is called for. Whereas in principle we agree to the two requirements, the amalgamation in point 27 is misleading: since certain risk concentrations – in some cases those across risk types – are recognised only in the context of stress tests (in this respect, see points 24, 29, 61), these often elude theoretical model approaches to measurement and therefore reliable objective pricing. The pricing concept in point 27 is also not defined in concrete terms, i.e. it remains unclear whether internal transfer pricing, arrangement of terms in customer transactions or benchmarks within the meaning of fair market prices are meant. In our view, concentration risk management, considering available counterbalancing capacities, aims to protect an institution from assuming excessively large risk exposures and to make it aware of this, but does not relate to pricing for the assumption of risks. In this respect, the requirement should be deleted from this point.

Point 35 could be interpreted as a requirement to subject all exposures to a limitation – which we do not consider appropriate. Rather, it should be ensured that suitable control mechanisms are implemented. In so far as these manage without limitations, the corresponding procedure should not be constricted unnecessarily. Limitation – especially for the risk concentrations arising from intra-risk exposures – as a rule already occurs on the basis of the normal risk measurement procedure.

Point 43 calls for a monitoring and reporting framework for risk concentrations. It should be clarified that here separate reporting is not necessarily required, but risk concentrations can be considered in the context of the regular risk reporting.

According to **point 47**, institutions are to determine their gross and net exposure to concentration risk. The point thereby implicitly assumes that concentration risks can be measured separately from the original risk types and underpinned with capital, which is not the case. The measurement of risk exposures at portfolio level regularly also includes the corresponding concentrations. Flat-rate separate capital cover for concentration risks would therefore lead to double cover under the ICAAP. The challenge for institutions consists more in the identification of concentration risks which have so far not been adequately addressed with the current models. For these, it is then necessary in each case to examine – especially in so far as they were determined in the context of stress tests – the extent to which capital cover is economically necessary and/or other measures are indicated.

Point 50 describes the concentration risks resulting from "common underlying factors". As regards the securitisations field, this has already been discussed in respect of CEBS CP 26 in the context of the requirements corresponding to Pillar I. We should like to refer to the discussions set out there and to emphasise two points in particular: A review of the corresponding underlyings is in many cases necessary, but nevertheless to be subject to materiality thresholds, i.e. not to be carried out per se in all cases. For transactions contracted up to and including 2010, transitional periods are also necessary, since the corresponding instruments and processes cannot be converted ad hoc. We should appreciate corresponding guidance in CP 31 so that the institutions are not faced with inappropriate requirements during the concrete on-the-spot checks.

CEBS states in **point 63** that VaR models may not capture market risk concentrations adequately. In conjunction with Guideline 7, it should be clarified that VaR models can continue to be used to assess concentration risks. In our view, the use of VaR models should not be called into question.

Management and supervision of concentration risk within individual risk areas

Point 78 (operational risk) calls for consideration of near misses and operational risk gains. A similar specification was already discussed in connection with the AMA. According to the currently valid interpretation, near misses and risk gains are not to be considered in the capital requirements modelling. However they may be applied in the context of control. Against this backdrop, a corresponding requirement should not be included in the context of the consideration of concentration risks.

Point 85 ff (Liquidity Risk) is concerned with the identification of risk concentrations within the liquidity risk. In particular, we would like to refer to the intended requirements of the Basel Committee ("International Framework for Liquidity Risk Measurement, Standard and Monitoring" on 17 December 2009) as well as the European Commission ("Possible further Change to the Capital Requirements Directive", February 2010) for the establishment of a uniform liquidity regime. As banks are expected to hold a stock of cash and high quality government bonds, risk concentrations could result which may have regulatory causes.

According to Guideline 14 (**point 92**), credit institutions must identify and monitor concentration risk in their funding sources. In this respect, the focus is on factors which may lead to a sudden, significant withdrawal of funds or deterioration in their access to funding sources. In the context of the sample list of individual products and sources, mention is made in the subparagraph on secured funding sources of covered bonds on a par with asset-backed commercial papers and securitisation of loans. We should like to point out that the German Pfandbrief is based on strict legal provisions and pronounced expert knowledge. Pursuant to legal provisions, a Pfandbrief cannot mature prematurely, so payment obligations arising from Pfandbriefe never occur unexpectedly. In addition, even during the acute phase of the financial market crisis, neither the primary nor the secondary Pfandbrief markets succumbed. It is true that the issues declined in volume, but issuing activity was consistently maintained. Whilst many funding sources contained in the list dried up completely, this was not the case for Pfandbriefe. We therefore suggest deleting covered bonds from the list.

For further questions we are always prepared to support you with detailed information.

Yours faithfully,

On behalf of
ZENTRALER KREDITAUSSCHUSS

Andrae H. Kämpfer

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