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Consultation Paper on Technical Aspects of Diversification under Pillar 2 (CP 20)

Dear Sir, Madam,

On 27 June 2008, CEBS published Consultation Paper 20, which looks at how risk diversification should be discussed within the framework of the so-called ICAAP-SREP dialogue between supervisors and institutions. The diversification effects dealt with in it are usually estimated for Pillar 2 purposes on the basis of internal economic capital (EC) models. According to CEBS itself, CP 20 is principles-based and designed purely to discuss accepted internal portfolio modelling practices.

The deadline for feedback on CP 20 is 31 October 2008. We are grateful for the opportunity to comment on this paper and wish to outline the position of the German banking industry in the following.

1. General remarks

Before commenting in detail on the ideas presented in the consultation paper, we should like to make a few general remarks.

. . .

CP 20 analyses and assesses internal bank thinking on the risk management methods used in calculation of economic capital, including the embedment of these methods in the organisational and operational structure within institutions. Its special focus is on the recognition of diversification effects. We expressly welcome it that CEBS's appreciates that internal recognition of such effects is an integral part of accepted bank risk management. At the same time, it remains unclear whether the paper is meant to cover all risk-bearing-capacity models (EC models in general) or whether it deals solely with the measurement of diversification effects.

Unlike the methods that can be used for prudential purposes under Pillar 1,

- which have a standardised structure,
- which must be comparable for various reasons among institutions and
- which greatly reduce in many respects the freedom institutions have in determining their capital requirements,

internal bank motives alone determine the use of EC models under Pillar 2. The restrictions that have to be accepted under Pillar 1 are inappropriate for the models suitable for bank management.

The internal estimates are based on the assumption of extreme losses (tail risk), as shown by the loss distribution quantile selected internally (99.95% and over), which is already much more conservative than the Pillar 1 requirements. It therefore makes little sense to call for additional margins of conservatism at various points in the consultation paper. The aforementioned thoughts apply all the more in view of the fact that uniform EC modelling practices have not yet emerged.

EC models are developed to support senior management in the task of calculating the size of the absolute economic capital requirements and allocating resources within the institution. It is therefore vital that as good and accurate an estimate as possible is made on the basis of realistic assumptions, taking the institution's risk profile into account. So it is no help whatsoever if institutions are forced – as explained during the CEBS hearing on 8 September 2008 – to make EC estimates for prudential purposes that differ from the EC estimates for internal purposes. Any divergence between internal "internal models" and external "internal models" must be avoided, not least because of the considerable additional burden imposed and the violation of the use test, but also because this would result in the measurement of diversification effects being detached from the internal risk management process.

If these yardsticks are applied, the paper is not sufficiently principles-based, but more prescriptive rules-based, and thus runs the risk of being inconsistent with the internal portfolio-based EC models.

The idea of bank- and portfolio-specific EC modelling is also incompatible with supervisors' benchmark models such as, for example, the individual capital guidance issued by the UK's Financial Services Authority (FSA), which we reject for this reason.

Our understanding of the paper is that it aims to achieve a broader common understanding among supervisors on the analysis of diversification effects. It is evidently designed as a tool for the ICAAP-SREP dialogue. We do not understand it as a set of requirements or timetable for a model-approval process. It is important that this view, which was also backed by the chairman of the responsible CEBS working group at the CEBS hearing on 8 September 2008, is explicitly pointed out. We therefore suggest that the final CEBS consultation paper should not be called "guidelines", but termed a document supporting the ICAAP-SREP dialogue.

CEBS recognises itself that the ICAAP is a bank-driven process (paragraph 9), which will be followed by a phase of dialogue with supervisors. This view should not be reversed by the dialogue creating requirements that have to be taken into account in advance in the ICAAP. The roles and responsibilities between institutions and supervisors should thus not be wrongly specified.

This assessment is shared by the Basel Committee on Banking Supervision. The Committee's chairman, Nout Wellink, said in June 2007: "*Pillar 2 really starts with you, the banks. First and foremost, responsibility lies with bank management for developing an internal capital assessment process and setting capital targets that are commensurate with the bank's risk profile and control environment. <….> Excessive participation by supervisors in a bank's capital adequacy assessment process or firms' over-reliance on supervisory review of their assessments are both counter to Basel II's objectives and raise the risk of moral hazard.*"

Unlike Pillar 1, a model-approval process like that required for internal market risk models, for example, is not something that should be handled in the ICAAP-SREP dialogue under Pillar 2. In our view, no provision is made for the "licensing" of EC models to be a condition for the recognition of diversification benefits within the ICAAP under Pillar 2, nor is it necessary.

It must therefore be asked how supervisors ultimately intend to use the very large amount of often highly institution-specific information that is gathered and that evidently serves in many cases to enhance prudential understanding, but does not have any added benefit for institutions

and is therefore also usually not available within them. This creates additional burdens for institutions when it comes to compiling and updating various documentation.

We suggest revising the consultation paper to ensure proper use of technical terminology (e.g. “correlation” and “diversification parameter”, which are not synonymous).

In our view, the paper does not differentiate enough between the needs and capabilities of smaller institutions and those of large – usually internationally operating – institutions. Thus, in accordance with the principle of proportionality, we believe that it is possible and prudentially acceptable for smaller institutions in particular not to use internal portfolio models. The recognition of interdependencies between different types of risk is enormously complex both in theory and in terms of implementation at a business level (e.g. because not enough empirically valid correlation data is available). For this reason, summation of different types of risk should be unrestrictedly possible at least for inter-risk, without this imposing any additional modelling requirements on smaller institutions. This approach should not disadvantage these institutions in any way.

The introduction in CP 20 should refer specifically to the principle of proportionality so that particularly smaller institutions with lower systemic risks are treated appropriately by supervisors with respect to their risk diversification models. That goes, for example, for reporting, the scope of documentation, validation cycles and data acquisition.

In the following, we now discuss the ideas put forward by CEBS that particularly need to be reconsidered in our view. We believe that the passages in question should be reworded or, if necessary, deleted.

Specific remarks

1. General overview of the capital model

Paragraph 12: While it is true that the prudentially desired additivity of the IRBA capital requirements was achieved by assuming an infinitely granular portfolio (Gordy paper), it does not follow from this that any portfolio diversification effects are overestimated. Rather, the prudentially specified assumptions regarding the level of asset correlation are so clearly inflated from an empirical perspective that often the opposite effect is produced. We suggest adding to this paragraph accordingly.

Paragraph 13: CEBS believes that the model risk described in this paragraph should be taken into account by means of conservative assumptions, stress testing and similar approaches. In our view, the causes of model risk mentioned by CEBS can be attributed at least partly to operational risk (bullet points 5, 6). While this risk should be taken into account, the extent to which this actually happens should be deliberately left open. The other causes of model risk mentioned here should be analysed within the framework of a qualitative and, if possible, quantitative validation process.

Paragraph 15, fourth bullet point: Because of the only limited amount of data available for it, testing the results from the models where 99.95% quantiles (and even higher quantiles depending on internal specifications) are usually used is generally impossible, but at any rate highly subjective.

Paragraph 15, sixth bullet point: Compiling and maintaining the documentation mentioned here would impose a considerable and, in our view, unnecessary burden. Moreover, there are institutions which have been working on their EC models for over ten years. Documenting all the options, weighting the advantages and disadvantages of individual approaches and explaining the choices made between different alternatives over a specified period of time are impossible. It is also not clear why such documentation should be necessary for the ICAAP-SREP dialogue.

Paragraph 16: CEBS says that it is important to ensure compatibility between various types of model which are used in the overall EC estimate. At the stage of model development at which we also find sophisticated banks, this is not possible for a foreseeable period of time. Such compatibility can only be achieved for models that are used for the same risk factors and at the same portfolio level. It also remains unclear what model incompatibility is supposed to mean.

Paragraph 19: According to this paragraph, institutions could be asked whether “all the relevant risk factors” have been included. Proof of such inclusion is not possible. Paragraph 19 should be deleted, as it raises unrealistic expectations. What is more, the quality of modelling is not automatically improved by increasing the number of risk factors included. Such a bottom-up approach is at odds with the principle of “economical modelling”. Top-down approaches to assess the adequacy of modelling are preferable (validation approaches).

Paragraph 20: According to this paragraph, summation is also regarded as an inter-risk aggregation model whose assumptions would logically have to be analysed. We believe that

this is inappropriate for such a conservative aggregation methodology. It should be made clear that summation is always unconditionally acceptable as an approach in this case.

Paragraph 25: The final sentence of the first bullet point could be misunderstood to mean that the requirements set in it, e.g. full access to information, apply unconditionally to external vendors. We therefore suggest deleting the final sentence.

Paragraph 26: This paragraph talks about the internal validation of external vendor models. While such validation may be desirable, it is frequently not possible. This is because the motive for using external models is often that institutions do not have enough data for model development and validation of their own. Moreover, internal validation would require disclosure of the entire database – particularly also information on non-listed companies such as SME clients, on retail clients or special finance/building finance – to estimate diversification parameters and review these critically.

2. Diversification parameters

Paragraph 33: As this paragraph itself implies, extending the time series does not automatically improve the quality of the results from models. This perception should, however, be emphasized more strongly. It is completely unclear what connection there is to be between the appropriateness of the length of a time series and capital planning factors.

Paragraph 39: According to this paragraph, a significant change in the risk profile, business strategy or risk appetite of an institution will be reflected in the correlation parameters. However, this is not true of modelling approaches in which correlations take into account the dependency of the respective risk factors and not the portfolio observed. The analogous argument in the second bullet point of paragraph 40 is likewise not generally true. Both passages should be amended accordingly.

Paragraph 48: The requirements proposed in this paragraph cannot normally be implemented, as they would seriously prejudice the interests of vendor model providers (cf. remarks on paragraph 26). This paragraph should therefore be deleted.

3. Reliability and conservatism of the methodology

Paragraph 53: When it comes to providing forward-looking estimates, we have doubts as to whether this idea can be fully taken into account in institutions' internal estimates.

Paragraph 55: This paragraph says that the less information an institution has of its own or the poorer the data situation is, the more conservative estimates should be. Such an approach is only possible naturally in the case of intra-risk modelling of loss distributions with a one-sided loss quantile. However, if losses and gains may occur simultaneously, a "conservative" approach can turn out to be less than conservative. This is possible for market risk and less – albeit to an increasing extent – for credit risk and operational risk. Any impression that supervisors expect margins of conservatism for every single estimated parameter should also be avoided. Where a large number of estimated parameters may exist, the margins of conservatism could add up, overall, to an exorbitant level.

Paragraph 58: The quantile assumption in each case allows EC models to determine unexpected losses already under extreme stress conditions. However, the respective correlation estimates should be consistent with the quantile observed. Here, too, conservatism is subject to tight limits: Because of the scarcity of the data needed to measure credit risk, the confidence bands for estimated parameters are very large, so that the parameters estimated on the basis of a high confidence level may differ widely from the corresponding point estimators. Particularly for highly granular portfolios, which are driven largely by systematic risk, the effects may lead to extreme and unrealistic EC estimates. Ultimately, an objective and understandable prudential assessment of what is meant by an "adequate margin of conservatism" (paragraph 58) is likely to be impossible.

Paragraph 61: This paragraph could be misunderstood to mean that regular transmission of the data in question to supervisors is planned. It should therefore be deleted.

4. Internal model validation

Section 4 appears to be a copy of the relevant passages of the CEBS consultation paper on validation (CP 10). It is thus wrongly assumed that the validation of EC models should be seen as similar to the validation of the IRBA input parameters such as PD or LGD. However, supervisors evidently believe (cf. paragraph 68) that the EC validation includes the validation of both the input parameters (e.g. correlations) and the results from the models (validation of

quantile estimates). No clear-cut distinction is made between these two very different validation approaches, though. An assessment by supervisors of what can – and, in particular, what cannot – be expected in the case of validation of extreme quantiles (99.5% and over) would be helpful. Because of the only limited amount of data available for it, testing the results from the models where 99.95% quantiles are usually used is generally impossible, but at any rate highly subjective.

Paragraph 66, first bullet point: The requirement that the model validation be performed by an internal function of the institution which is independent from the model design and development was discussed in detail within the framework of the consultation on CP 10. Such a requirement would impose a serious burden on institutions, as the number of model specialists for EC models is too limited to ensure such independence. Furthermore, personnel resources are available in the internal audit function (or a comparable function) (cf. paragraphs 72, 73).

5. Internal decision-making processes

Paragraph 75: Internal decision-making processes in connection with conclusion of a transaction often focus on one type of risk (e.g. transfer of credit risk). Diversification then plays more of a secondary role in the processes. We would welcome further specification of the objective of this paragraph, which remains unclear.

Paragraphs 76, 77 and 82: It is unrealistic to assume that senior management and board members could be informed meaningfully about technical EC modelling details such as the sensitivity of the diversification input parameters. Such a profound understanding of technical details cannot be expected of senior management and even less of board members.

6. Comparing results of Pillar 2 and Pillar 1 capital calculations

It is important in our view to make clear that differences between the results of regulatory and economic capital calculations do not lead to additional capital requirements. It is a mistake to believe that the results from Pillar 2 models are suitable for supplementing the regulatory capital requirements in Pillar 1. This is not the purpose of Pillar 2 results. It is, for example, overlooked that the quantitative results of both approaches are usually based on completely different methodologies which are not comparable (especially not for institutions which do not

use any model approaches for prudential purposes), much less nettable. Thus, any plausibilisation of Pillar 2 capital calculations with the help of Pillar 1 capital numbers would also make little sense even for the assessment of intra-risk diversification. Instead, differences merely reveal the shortcomings of prudential risk measurement.

Paragraph 86: A comparison of Pillar 1 and Pillar 2 capital numbers also makes little sense for the assessment of inter-risk diversification, as the additive approach for calculating the capital requirements under Pillar 1 means that there is no reference point for a comparison.

Paragraph 87: This requirement is unnecessary in our view, as it only imposes burdens on institutions, without producing any additional benefit. Ultimately, supervisors would merely be informed about the shortcomings of Basel II. This is not the purpose of the ICAAP-SREP dialogue, however.

Paragraph 88: In line with our assumption that the Pillar 2 capital calculations are independent from the Pillar 1 capital numbers, we presume that the ICAAP-SREP dialogue is to be conducted not only with IRBA institutions.

Paragraphs 90 – 94: These paragraphs should be deleted because – as already explained – the Pillar 2 models are not suitable for supplementing the regulatory capital requirements under Pillar 1.

7. Group dimension

This section of the consultation paper gives greater weight to the inclusion of the host supervisor on questions concerning group-wide capital allocation. Taking into account the characteristics of diversification (e.g. the sub-additivity of the allocation of economic capital across various levels of an institution’s organisation) and the fact that an analysis makes sense primarily at group level, the home supervisor’s leading role should be stressed so as to avoid raising any expectations than cannot be fulfilled. At the same time, we appreciate that an analysis of risk-bearing capacity may make sense in certain situations also at the level of a subsidiary.

Paragraphs 98 – 100: The issues addressed here are out of place in a paper dealing with technical aspects of diversification within an EC model, i.e. the calculation of economic capital requirements, taking into account diversification effects. They are in fact about satisfying the

capital requirements via various capital elements. While this is by all means also a Pillar 2 issue, it should be discussed elsewhere. Paragraphs 98 – 100 should be deleted.

Annex

With regard to the list of questions contained in the Annex, we wish to point out that it must not lead to any hard tick-list of requirements for the representatives of banking supervisors taking part in the ICAAP dialogue. This would be at odds with the prudential concept of Pillar 2.

Yours sincerely,
on behalf of the Zentraler Kreditausschuss
Bundesverband deutscher Banken

Dirk Jäger

Uwe Gaumert