POSITION PAPER

ESBG Response to:
CEBS Consultation paper on technical aspects of diversification under Pillar 2

30 October 2008

ESBG

The ESBG welcomes the opportunity to comment on CEBS' consultation paper concerning its proposed technical approach to understanding claims for diversification benefits arising from internal models used by supervised institutions for Pillar 2 purposes.

CEBS paper sets high standards for ICAAP modeling, verification, and validation. The ESBG would like to underline that ICAAP is an emerging topic and in many respects industry standards are still in a development phase. In this context and as a preliminary remark we would suggest that CEBS **refrains from giving too specific and ambitious requirements on the model side** and concentrates rather on those issues where most value can be generated.

The ESBG welcomes the recognition by CEBS that the internal incorporation of diversification effects is an integral part of the accepted risk management methods in the banking business. However, it still remains unclear whether the CEBS paper refers to all risk-bearing capacity models, i.e. economic capital models in general, or whether it deals exclusively with the measurement of diversification effects. We would appreciate it **if CEBS would describe more specifically the scope of its paper**.

Furthermore, the ESBG argues in favour of a **more principles-based approach**. The current wording often implies a rather prescriptive rules-based approach that entails the risk of contradicting internal capital models commensurate with the specific portfolios.

It is important to highlight that, contrary to methods used under Pillar 1, which for supervisory purposes are constrained by regulatory requirements, the use of economic capital models under Pillar 2 is determined only by reasons internal to the bank and therefore should not be constrained by regulatory limitations. Furthermore, in order to secure the efficiency of the overall Basel II approach it is essential to consider Pillar 1 and Pillar 2 requirements independently from each other, and to avoid using information stemming from Pillar 2 for determining Pillar 1 requirements. Internal assessments are based on the assumption of extreme losses (tail-risk) resulting from the internally chosen quantile of loss distribution (99,95% or above), which is obviously more conservative than the Pillar 1 requirements. Taking this into account, we believe that **it is not advisable to insist on supplementary "margins of conservatism"** as it is done on various occasions in the CEBS paper.

Moreover, the paper appears sometimes to promote the assessment of economic capital for supervisory purposes thereby deviating from the assessment of capital for internal purposes. This **divergence between *internal* "internal models" and *external* "internal models" is not acceptable** and could ultimately lead to the decoupling of the measurement of diversification effects from the internal risk management process.

The ESBG comprehends that the purpose of CEBS paper is to develop a common understanding among supervisory authorities on the analysis of diversification effects and thereby to provide support for the ICAAP-SREP dialogue. The ICAAP process is bank-driven and only subsequently followed by a dialogue phase with the supervisors. This sequence and the attribution of roles between institutions and supervisors is key to its efficiency and should not be reversed. It is therefore **essential for the CEBS paper not to be understood as a list of requirements** or a roadmap for the acceptance/approval of economic models. The ESBG urges CEBS to make this explicit in the text of the paper. For this reason as well, it would be advisable not to give the status of "guideline" to the final CEBS work on diversification, but to designate it merely as a support document for the ICAAP-SREP dialogue.

We would like to draw attention to the fact that the paper requires increased provision of information to supervisors, which would entail additional burden for banks related to the compilation and updating of the relevant documentation. However, it should be reminded that in the framework of ICAAP under Pillar 2 there is no requirement and also no need for an approval of capital models, and that very often, such supplementary, institution-specific information helps only the understanding of supervisors, but brings no additional value for the institutions. In this context, CEBS should ensure that **costs and benefits in relation to the provision of supplementary information are equitable**.

As mentioned in the paper, data instability is a challenge all banks face. Even in the theoretical case of perfect data quality, there is still the statistical phenomenon known as bias/variance problem. A complex model might in theory very well describe the environment (low bias), but estimating the model parameters out of real world data might prove to be instable (high variance) due to data scarcity. In such cases, it is often better to **opt for simple models** which might not perfectly fit (high bias), but can be stably estimated (low variance). The ESBG urges CEBS and regulators in general to keep this in mind, when complex models (e.g. copulas) are proposed.

There are many requirements / expectations in the document or questions in the Annex concerning diversification, but it is not always clear whether they are related to **intra-risk or inter-risk diversification** or both. From this perspective, CEBS is encouraged to be more precise. Also, some requirements seem too strong in case of diversification among risk types.

Last but not least, in our opinion, the paper does not sufficiently differentiate between the needs and capacities of smaller and bigger institutions. For instance, smaller institutions usually do not use internal portfolio models. Also, the due consideration of interdependencies between the various risk types is extremely complex for small banks, especially because of the scarcity of empirically valid correlation data. In light of such differences, the ESBG suggests that **proportionality be inserted as an overarching principle** in the introduction of the CEBS paper. This should ensure that supervisors take a balanced approach when considering risk diversification models of smaller institutions that entail reduced systemic risks. Such proportionality should be reflected as regards supervisory expectations in terms of reporting, documentation, validation cycles, and data provision.

About ESBG (European Savings Banks Group)

ESBG (European Savings Banks Group) is an international banking association that represents one of the largest European retail banking networks, comprising about one third of the retail banking market in Europe, with total assets of € 5215 billion (1 January 2006). It represents the interest of its Members vis-à-vis the EU Institutions and generates, facilitates and manages high quality cross-border banking projects.

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