European Banking Federation

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The EBF is committed to supporting EU policies to promote the single market in financial services in general and in banking activities in particular. It advocates free and fair competition in the EU and world markets and supports the banks' efforts to increase their efficiency and competitiveness.

CEBS Guidelines on Concentration Risk

EBF Response to CEBS CP 31

GENERAL REMARKS

The EBF welcomes the work carried out by CEBS in preparing the guidelines for concentration risk as long as they contribute to set common standards throughout the European Union. The EBF has long pursued the issuance of clear guidelines in all matters within the supervisory scope. We understand CEBS's desire to promote good industry practice among firms and found CEBS's draft principles and guidance useful and thought-provoking.

However, the EBF has three main differences in the interpretation of concentration risk that CEBS should consider in general when assessing any matter related to concentration risk:

- Concentration is not a new risk type but a feature within other risks. It should be clarified that institutions are not required to identify a certain amount of their capital specifically meant to cover concentration risk, but that capital requirements are calculated as a whole against the totality of risks banks face. Therefore it should not be treated separately. We understand this rationale to be in the spirit of guideline 7 but would claim for more clarity. Moreover, the way concentrations are dealt with in economic capital models is through correlations and by estimating the sensitivity of portfolios and counterparties to a set of risk factors, whereby it is identified how much they relate to the same common factors. Where separate reporting of single name concentrations, and sector and product concentrations in absolute amounts is feasible, reporting of general intra-risk and inter-risk concentrations is challenging when these are incorporated in economic capital models because they are calculated together with diversification.

- Concentration risk and diversification should always be assessed jointly (they are heads and tails). Diversification might have been overestimated in certain asset classes in the recent past, but it is also true that a well-diversified structure makes an institution more resilient and should be incentivized as a good risk management practice. Thus we would suggest including in guideline 7 a mention to the combined assessment of both concentration risk and diversification of the bank under the ICAAP. Moreover, the CEBS is known to be preparing new guidelines on capital allocation that will cover the issue of diversification. We recall that they should be put in place at the same time as these guidelines on concentration risk.

- Concentration risk as described in the CEBS draft principles includes several distinct topics that needs to be addressed in different ways, including :
    - Elements of systemic risk (as described in Appendix 1) that are the remit of macro-prudential supervision rather than pure concentration risk management at each bank level
    - Complex chain-reaction type of events that involve the successive occurrence of contingent risks (e.g. liquidity risk) that can only be addressed through scenario analysis and stress-testing

Other general remarks of the EBF refer to the following matters:

- Supervisors should recognise that certain concentrations of risk, especially those that arise across risk types (i.e. inter-risk) are difficult to evaluate in quantitative manner (in particular if it has to be separated from the diversification effects) and consequently recognise the validity of a large array of approaches such as stress tests, scenario analysis backed by experts' judgement, qualitative analysis and when possible, modelling.
- The EBF warns against the risk that the newly proposed CRD4 may drive banks to heap single asset classes or a restricted type of assets onto their balance sheets. In particular, the new liquidity standards restricting liquidity buffers to a limited group of assets and the new capital standards emphasizing the use of common shares may go against Section 4.4 of the CEBS paper.
- The industry acknowledges the need for adequate internal reporting and appreciates the flexibility offered to institutions in the design of its own reporting methods. The guidance of CEBS on reporting of concentration risk is welcome as long as it is principle-based and allows for banks to define their own reporting methods. This line should be followed by national supervisors when it comes to implement and review specific reports.
- Guidance on the measurement of concentration risk at national level has already been produced by Central Banks or Banking Associations, especially as an aid for smaller banks. We expect them to be in line with the CEBS guidelines, but there should be a call for harmonisation among European countries in order to avoid potential conflicts stemming from differing legacy norms or national guidelines.
- We welcome the explicit respect for the principle of proportionality.
- Dependency of profits on a single business or sector is a matter of business risk, which is part of the ICAAP process. Focus on concentration risk should not undermine the position of many small specialised banks.
- Regarding inter-risk concentration, we generally agree that the interaction between positions of different risk types should be examined. But modelling inter-risk concentration appears an arduous task not least an extremely sophisticated work. The models available for this purpose are not of a comparable standard and banks would need more time and experience to develop inter-risk models. For this reason, many

banks will have to analyse concentration risk across risk types primarily by means of stress testing and scenario analysis as well as qualitative analysis.

- We welcome the flexibility of CEBS towards the implementation of the guidelines (points 12 and 13) and the recognition of the possibility of a phased implementation. Firstly, banks should start managing concentration risk within each silo (credit, market, operational). In a second step, the scope would be extended to a firm-wide view.

SPECIFIC COMMENTS

Guideline 1:

It is broadly accepted that concentration risk should be adequately addressed in the governance and risk management frameworks of banks.

With regard to materiality, the CEBS approach of leaving firms to determine their tolerance is correct and avoids prescription.

It should be clarified that concentration risk should only be addressed at consolidated level for large banking groups, as material concentrations (as defined in par. 14) only appear at group level. Concentrations at solo level are primarily driven by legal entities specific businesses and locations along with local economies' intrinsic concentrations, and are largely irrelevant as they diversify at group level.

Guidelines 3 and 4:

We welcome the suggestion that stress testing is a means of identifying concentration risk stemming from both intra- and inter-risk concentrations. The Basel Committee and certain supervisors – such as the UK Financial Services Authority - have put forward proposals on stress and scenario testing, including reverse stress testing – some of which are currently being implemented by banks -. These initiatives will assist with the monitoring and mitigation of such risks.

Supervisors should recognise that some concentrations, esp. inter-risk concentrations are intrinsically difficult to quantify and that experts' judgment should apply.

As regards paragraph 27, banks are required to price risks correctly and, at the same time, they are called on to adopt a forward-looking approach to concentration risk management. While we basically agree with both requirements, we believe it is misleading to mention them together, since certain concentrations of risk, especially those that arise across risk types, can only be identified by stress tests as acknowledged in the same guideline. It is often not possible to measure them with the help of models. As a result, their pricing will not always be reliable. On top of this, realistic market prices for taking on risks are based on the assumption that portfolios are diversified and normally will not reflect a bank-specific concentration of risk. Concentration risk management therefore aims at protecting the bank from taking on risk positions which would exceed its counterbalancing capacities and at sensitising the bank to the dangers of such exposure. It is not, however, involved in risk pricing. Hence we suggest deleting this requirement from paragraph 27.

Guideline 5:

We agree and appreciate the examples detailed. The use of key risk indicators is commonplace among European banks, acting as an early warning system. These are collated for risk committees to review.

Many supervisors already reviewed the functioning of risk control systems on a regular basis. Controlling, monitoring and mitigating concentration risk should part of the risk assessment in any institution.

We feel however that it should be clarified that the requirement to set formal limit structures should only apply where it is appropriate based on the institution's own judgment.

Guideline 6:

The guidance of CEBS on reporting of concentration risk is welcome as long as it is principle-based and allows for banks to define their own reporting methods. This line should be followed by national supervisors when it comes to implement and review specific reports.

We would suggest making it clearer that an additional, dedicated reporting framework is not necessary and that risk concentrations can be addressed in existing risk reports.

There are different levels of application, consolidated, solo and legal entity. There are also different approaches, top-down and bottom-up. It should be left to firms to work out what is best for them/their business models.

Guidelines 7 and 20:

Our opinion is that concentration risks should be one output, among others, of the stress testing process. All the more so as it is a key item in the banks ICAAP and capital planning frameworks as stated in the CEBS guideline.

However, we would like to draw the attention of CEBS to the wide-scoping nature of the ICAAP. All features of a bank should be considered altogether and not in an isolated approach. In this vein, concentration risk should be assessed from the overall perspective of the banking group, together with the portfolio structure and diversification characteristics.

We strongly oppose the view that concentration risk should be assigned additional capital itself. For this reason, we would encourage CEBS to be more explicit in this guideline as regards the overall assessment of an institution in which the risk of concentrations is just a part of the entity's risk profile.

The guideline appears to imply that concentration risk can be measured independently of the underlying risks involved and subjected to a separate capital charge. This would not be the case. Concentrations are normally captured when risk positions are measured at portfolio level. An across-the-board additional capital charge for concentration risk would consequently result in a duplication of capital requirements calculated under the bank's ICAAP. The real challenge facing banks is to identify concentrations of risk which have not as yet been adequately addressed with the help of established models. These risk concentrations, especially if they have been uncovered in the course of stress testing, must then be analysed to ascertain to what extent they need to be backed by regulatory capital or what other measures are appropriate

Guidelines 8, 9 and 10:

We broadly agree and welcome the guidance.

Guideline 11:

We agree and welcome the illustrated examples and the CEBS's intention to revise guidance after further study.

We find however very unlikely that high frequency/medium impact (HFMI) would jeopardise the survival of an institution (as indicated par. 73) as they would trigger corrective measures before doing so.

It is not clear to what extent CEBS is describing a future panacea of best practice against what is needed today.

Also, it is not clear whether a firm should meet all of the principles or only those that are appropriate for its business model or, having identified gaps in practice, work towards eliminating them.

Guideline 12:

We agree that institutions should use appropriate tools to assess their exposure to operational risk concentration. As a matter of example, UK banks have key risk indicators (KRIs) in place, acting as an early warning system. These are collated for risk committees, which include representatives from Internal Audit, Operational Risk and, often, Compliance, to review. UK firms are assessed on business continuity by both the FSA and internal risk control functions in accordance with the FSA's Senior Management Arrangements, Systems and Controls (SYSC) handbook (which also requires stress testing, as discussed above).

Guideline 14:

The Basel Committee's consultation paper on "International framework for liquidity risk measurement, standards and monitoring", as well as new liquidity rules introduced in some jurisdictions, introduce two new measures of liquidity risk exposures, one short-term and one long-term .Hence there will be additional monitoring and there is a link between the availability and monitoring of unencumbered assets with recovery and resolution plans. As well as these hard tests, regulators are also required to monitor the overall funding and liquidity profile of banks.

Uniformity of application is important. Firms should not be disadvantaged depending on their supervisor. The review after 12 months is welcome.

Guideline 17:

With regard to Risk Assessment Systems, we counsel that qualitative comments are as important as the figures. Results should not be compared without an understanding of business models and discussions with management.

Guideline 18:

We agree, but point out that supervisors already hold and have exercised the referred power as set out in the Article 136 of the CRD. As stated in the key messages, additional capital is not the only means of mitigating concentration risk.

Guideline 19:

It should be noted that new global and some domestic proposals address capital and liquidity buffers. Supervisors already hold and have exercised the power to increase capital and reduce risk. As stated in the key messages, additional capital is not the only means of mitigating concentration risk.

Nevertheless, the EBF wishes to recall that measures of this nature should only be imposed after having taken all the steps of a sound supervisory review process, what involves: firstly, to ensure a fair understanding of the bank risk profile by establishing a dialogue with the institution, secondly, to challenge the methods and make recommendations geared to find common ground and, only as a last resort, to oblige the bank to hold own funds in excess of the minimum requirement.

Guideline 21:

We agree with the assertion that "a balanced view thus has to be taken when assessing the focused activity that may inherently lead to concentrated exposures". For example, many of our members are private banks or institutions catering for particular sectors, for example charities, leisure, development etc. They have the expertise to manage such bespoke services and risks and this fact should also be considered.

It is important to guard against unintended consequences and prescription. For example, a niche operator will know its clients and markets. Therefore, the guidance should distinguish between cross-border banks and smaller firms, and not try to shoehorn institutions towards diversification that they may not understand, for example clients and markets that they do not usually cater to.

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