POSITION PAPER

ESBG Position in the CEBS consultation on "CEBS Guidelines on aspects of the management of concentration risk under the supervisory review process" (CP 31)

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ESBG

ESBG appreciates the opportunity to contribute in the CEBS consultation on "CEBS Guidelines on aspects of the management of concentration risk under the supervisory review process".

General Comments

ESBG shares CEBS' assessment that unrecognised and unmitigated concentration risk can be an important cause of losses at credit institutions and therefore welcomes the attention dedicated by CEBS to this risk. However, ESBG would like to highlight the importance of banks' business models for the exposure to and mitigation of concentration risk. We also would like to put forward some general comments on CEBS' proposal.

General approach taken by CEBS

As regards CEBS' general approach, ESBG would like to underline its support for the distinction between concentration risk within risk areas ('intra risk') and concentration risk across risk areas ('inter risk'). However, we would point out that currently the approaches to model and measure 'inter risk' are by far not as advanced as in the established tests and measures which already may capture 'intra risk'. At least for the next years, 'inter-risk' may therefore be modelled and assessed with a lower degree of sophistication.

Concerning the understanding of concentration risk as such, ESBG would ask for more clarification. ESBG takes the view that it is important to stress that concentration risk is not introduced as a new risk category per se, but defines the risk that one particular risk driver leads to increased and (more or less) simultaneous shortfalls, write-downs or losses within one risk area or across risk areas. On this basis, we would request clarification in how far CEBS recommends an extra stress testing process with a focus on concentration risk. The same applies to the reporting process and the limit structure. ESBG believes it to be more appropriate not to introduce an extra stress test for concentration risk, but rather to (further) integrate the assessment of occurrences of concentration risk due to shared risk drivers into existing stress testing and reporting.

The present guidelines seem to put great weight on a quantitative approach to measuring concentration risk. ESBG would, however, urge to also allow for more qualitative approaches – where appropriate given the risk area and the bank's business model. This would mitigate the effect of the sensitivity of risk models to the underlying assumptions, and could yield more reliable results, depending on a bank's business model and credit portfolios.

As regards the recommended measures to mitigate exposure to concentration risk, ESBG would stress that imposing higher capital requirements is only one possible treatment. In this context it would be helpful if CEBS clarified that its goal is not to create additional capital coverage labelled as addressing concentration risk, but that it seeks to ensure that banks *understand* concentration risk and act accordingly. Furthermore, we would invite CEBS to underline that it does not urge for diversification of business activities (or similar interventions in banks' business models) as a mitigation measure for identified concentration risk exposures. In particular, there should not be any pressure for financial institutions to embark on activities or enter markets where they may lack the necessary expertise or for which their structure or their business model is not fitting.

With view on national supervisors' assessment of banks' measure and treatment of exposures to concentration risk, ESBG would urge supervisors to be transparent about their decision making process. This would have the additional benefit of facilitating comparability of supervisors' approaches across the EU.

Application within the financial sector

As regards the targeting of the guidelines on the various credit institutions, ESBG very much welcomes the adherence to the principle of proportionality. Nevertheless we are apprehensive that the current guidelines may be overly concerned with the unmitigated exposure to concentration risk in the credit portfolios of smaller, regionally active lenders. Here ESBG would like to stress the importance of a bank's local knowledge, where geographic concentration directly translates into expertise regarding the market concerned. Especially for retail banks with a focus on lending to the local economy, credit risk tends to be spread across various industry sectors, which in turn leads to a diversified portfolio in real economic terms. ESBG would therefore urge to take into account the mitigation effect of such banks' business models for the 'real' exposure to risk concentrations.

Concerning the application of the guidelines as regards banking groups, the question arises whether exposures to risk concentrations should be measured and addressed at the level of the individual entity or at the group level. ESBG would like to point out that categorically insisting on the measurement of concentration risk at the level of individual entities could be problematic.

Implementation deadlines

Looking ahead, ESBG requests that the timeline for implementation be clarified. In particular, it is important to underline that 31.12.2010 is the implementation deadline for transposition by the national supervisors / into national law, but not for implementation by individual banks. This would be a challenge given substantial necessary changes to banks' IT systems, adaptation in stress testing procedures, additional data requirements etc.

<u>Specific Comments</u>

§ 13: ESBG would welcome more details on how and when the implementation study is to be conducted.

§ 27: The requirement that institutions should price risks with view on potential evolutions in financial markets and the economic environment is, in itself, logical. However, it should not be interpreted as a requirement to concretely price in concentration risk. Fulfilling such a requirement would indeed be difficult; also it would not necessarily yield objective and satisfying results: Concentration risk may not be measurable to a sufficient degree of precision, is highly sensitive on the model used, and may furthermore only become evident ex-post during stress tests. ESBG upholds as well that the identification and measurement of concentration risk should protect institutions from excessive risk exposures; however, it is not suitable in defining the prices to be charged for risk itself. Hence, the paragraph should be clarified along these lines or be deleted.

§ 35: The call for top-down and group-wide concentration risk limits could be interpreted as an instruction to limit all exposures. ESBG would ask for clarification so that such an interpretation be avoided. Furthermore, we are highly doubtful that absolute limits or benchmarks above which concentration risk exists and/or becomes problematic can be established in the first place.

§ 43: A "monitoring and reporting framework for risk concentrations" should be integrated into the general risk reporting already taking place. A separate reporting process is not called for – double reporting may even lead to less efficient reporting.

§ 47: The notion that institutions should assess their gross and net exposure to concentration risk suggests that concentration risk can be quantified separately from the general risk categories within/across which it manifests itself. ESBG does not see how this should be possible in a reliable and adequate manner. Accordingly, we are also very sceptical concerning the idea to allocate extra capital to what would be derived as an unmitigated net exposure to concentration risk. Since within portfolios concentration risk is already measured to a large extent, requesting additional capital to be allocated to cover any derived overall net-exposure to concentration risk could lead to doubling the capital allocated within ICAAP in order to address concentration risk within a risk area. Thus ESBG rather believes that the main challenge for institutions is to identify those occurrences of concentration risk which their current models have not been able to capture sufficiently. For such cases, there will be a need to investigate whether extra capital is called for or whether other mitigation measures would be more effective.

§ 63: CEBS considers that VaR models may not adequately capture market risk concentrations, since VaR measures may not reflect stressed market conditions. ESBG does not agree with this line of reasoning, since concentration risk does not necessarily build on stress risk. Therefore we find that VaR models can be used for the identification of risk concentrations. We would invite CEBS to clarify that, as such, the applicability of VaR models in this context is not questioned.

§ 65: The assessment of concentration risk should take into account market related liquidity risk and the resulting changes in liquidity horizons. ESBG recognises the merit of considering this aspect, for example, in context of stress tests for liquidity risk where no limits to such risk are imposed. However, as regards the limitation of risk, ESBG does not consider it factual to take into account the risk of changing liquidity horizons. Here, we would ask CEBS for clarification.

§ 111 – 113: ESBG welcomes that CEBS considers that expertise and local knowledge contribute to the quality of risk management and may therefore mitigate the exposure to concentration risk. However, we would urge that in this context not only those institutions with a focus on selected products or categories of borrowers be mentioned. The argument of "relatively better portfolio quality given the greater local knowledge" equally applies to long-standing regionally oriented retail banks. ESBG therefore stresses that such banks should be included among the institutions where the benefits of local expertise are recognised as risk mitigating factors.

About ESBG (European Savings Banks Group)

ESBG – The European Voice of Savings and Retail Banking

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 € 5,972 billion (1 January 2008). It represents the interests of its members vis-à-vis the EU Institutions and generates, facilitates and manages high quality cross-border banking projects.

ESBG members are typically savings and *retail* banks or associations thereof. They are often organised in decentralised networks and offer their services throughout their *region*. ESBG member banks have reinvested *responsibly* in their region for many decades and are one distinct benchmark for corporate social responsibility activities throughout Europe and the world.

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