European Association of Co-operative Banks
Groupement Européen des Banques Coopératives
Europäische Vereinigung der Genossenschaftsbanken

Committee of European
Banking Supervisors

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Consultation Paper (CP 20) on technical aspects of diversification under Pillar 2

Ladies, Gentlemen,

The European Association of Cooperative Banks (EACB) welcomes opportunity to comment on CEBS's current thinking on technical aspects of diversification under pillar 2.

Please find our remarks expanded on the following pages. Please do not hesitate to come back to us for any questions.

Yours sincerely,

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OVERALL REMARKS

The EACB appreciates the principle based approach and the core objective of this consultation paper 'to provide the basis for an on-going dialogue between the supervisors and the industry'. We believe that an ongoing dialogue is the essential part of the Supervisory Review & Evaluation Process (SREP), especially for the modelling of diversification under Pillar 2.

In this regard we would like to emphasize that the establishment of the Internal Capital Adequacy Assessment Process (ICAAP), and thus modelling diversification, is solely the responsibility of an individual bank. ICAAP is a set of policies, methodologies, techniques, and procedures to assess the capital adequacy requirements **in relation to the bank's risk profile** and effectiveness of its risk management, control environment and **strategic planning**.

Thus it should be clarified that does not define conditions for the recognition of diversification aspects under pillar 2 and thus create new prudential requirement. In fact, as CEBS correctly underlines, the ICAAP is a "bank driven process", followed by a discussion with supervisors. Nor should the impression be raise that it sets requirements for the validation of diversification effects under banks' economic capital models.

In order to ensure the aforesaid, it should be stressed in the introduction to the paper that the SRP implies an obligation for banks:

- To have in place sound, effective and complete strategies and processes to assess and maintain on an ongoing basis the amounts, types and distribution of internal capital that they consider adequate to cover the nature and level of the risks to which they are or might be exposed (article 123 CRD),
- and that Competent authorities shall require any credit institution that does not meet the requirements of this Directive to take the necessary actions or steps at an early stage to address the situation (article 136 CRD).

General Comments

In general the EACB supports the CEBS technical aspects and believes that it is a step in the right direction for modelling diversification under Pillar 2. However, we are of the opinion that:

- The chosen risk appetite of a financial institution, as a core consideration in the strategic planning process, i.e. Economic Capital / ICAAP process, is a basic principle of modelling Pillar 2 processes. The risk appetite reflects the level of conservatism an institution has defining their internal view of solvency capital adequacy. This means that the risk appetite is also expressed within the framework of risk diversification under Pillar 2.
  Bearing in mind that a growing number of banks world wide use ICAAP/economic capital to steer their business, the EACB would strongly suggest to add ‘risk appetite’ as a starting point in the “1. General overview of the capital model”, as well as in the “5.2 Decision making process and reporting”.
- Bank management is solely responsible for establishing strong internal processes that state capital adequacy goals with respect to risks. Having already stated, diversification aspects are taken into account in the calculation of the adequate capital level.
  If a supervisor requests an institution, within the scope of SREP, to apply more conservative parameters in the internal capital model, this will result in skewed risk / return analyses. We firmly believe that if a regulator does have a more conservative view regarding the framework of risk diversification under Pillar 2, he can eventually as a result of the SREP process, as a last resort, apply an add-on to the total capital level but should not distort the capital calculation of the institution itself.
- However, any differences between the calculation of economic capital under pillar 2 and prudential capital should not automatically lead to additional capital requirements. In our view, there might be a need to adapt internal processes when the margin is too substantial. On other hand, we think that it will be impossible that calculations under pillar 1 and pillar 2 lead to identical results. Both approaches are based on fully diverging approaches that are not comparable. It has to be recalled in this respect that also under pillar 1 the results under the standardized approach may differ from IRB approaches.
- Especially with regard to the aforesaid, we think that the document does not consider, to a sufficient degree, the needs and possibilities of smaller banks (proportionality aspects), but is too much focused on bigger international banks. We definitely see a need to mention proportionality also in the introduction to this paper.
  In particular, there is nothing to object from the prudential point of view, when smaller institutions do not use internal portfolio-models for the purposes of pillar 2. The consideration of interdependencies between different kinds of risk is very difficult and complex in theory. Its implementation in banks’ internal processes is even more difficult and

complex, for many reasons (e.g. due to the lack of valid empirical data on correlation). For this reason we think that for the intra-risk-aggregation a simple addition of the different kinds of risk must be possible in order to avoid too far-reaching requirements for the models of smaller banks.
We also think that proportionality requires that formal prudential requirements for diversification models of smaller banks should be moderate and in line with their systemic relevance, such as reporting, documentation requirements, validation cycles and provision of data.

- The document on diversification contains many generic statements that are already covered by the ICAAP guidelines. Examples of these are paragraphs 14-19, 63 - 74, but many more. Further the paper for a large part discusses compliance and governance in reference to capital models used, rather than to specifically addressing issues in respect of the calculation and assessment of diversification benefits. On the one hand that means that the paper can be shortened by avoiding the general capital model discussion; at the same time it should be expanded by including more discussion on the methodologies to estimate diversification benefits.

- Transferability is entirely a legal issue and should therefore separately dealt with. Banks manage risks on a central group level basis, in which transferability is neither a measurement issue nor a modelling issue with respect to diversification of risks. We strongly believe that transferability should therefore not be treated as a part of the technical aspects of diversification.
  If CEBS would like to maintain this section we would like to suggest to write additional guidelines / technical input on this topic. In addition, if the supervisors believe that capital add-ons due to non-transferability of capital is requisite, this should be consistently applied to all global banks to ensure a fair level playing ground.

- The distinction between different types of risk diversification is an important aspect of the framework of risk diversification under Pillar 1and Pillar 2. Diversification within one risk type, also known as intra risk, is a natural component of Pillar 1 capital calculations, for market risk, for IRB (credit risk) and for most AMA models (operational risk). Diversification between different risk types, also known as inter risk diversification, is covered under Pillar 2.
  The insurance industry recognizes the following split1: (i) diversification between (sub)risk types within an entity, (ii) diversification between entities within a (sub)risk and (iii) diversification between risk types and entities. We suggest to make a clear distinction between different types of risk diversification in section "6.3. Addressing the risk types".

- Finally, the question remains about the added value that supervisors can draw from the vast amount of information that needs to be generated, especially with regard to banks of lesser systemic relevance. The preparation and update of the information should be aligned to supervisory needs and impose burdensome exercises on banks without any need.

SPECIFIC ISSUES

Stability of Framework

The framework of risk diversification foremost should be 'robust' in normal and stressed conditions, and not necessarily 'stable'. Correlation parameters do change if market conditions alter. We would propose to adjust the words 'stable and/or stability' in 'robust and/or robustness' of correlation estimates throughout the consultation paper.

"Claimed Diversification"

The wording 'claim(ed) diversification' (like in paragraphs 64, 67, 69, 75, 80, 82 and 85) may have an undesired connotation as in 'claimed territory'. In general institutions are interested to estimate their risks as accurately as possible as both an underestimation and an overestimation of risk will lead to competitive disadvantages. In that light we would suggest to use the wording 'estimate (d) diversification'.

Nr. 25

Requirements regarding the institution's knowledge concerning the development of the external vendors should reflect realities. Unlimited access would be far from realistic.

Nr. 26

Nr. 26 refers to the validation of external vendor-models. While such validation may be desirable, it will not be realistic in many cases. In fact, the reasons for the uses of often external models is quite often owed to the fact that there no sufficient data for establishing and validating internal models. Furthermore, internal validation would require the disclosure of the complete data material, including those of non-listed companies in order to ensure their critical assessment. Furthermore, such disclosure may seriously affect the business-models of suppliers of vendor-models.

Nr. 48

We have serious doubts that the requirements mentioned in this paragraph are realistic, when vendor-models are used. Such disclosure would seriously affect the business model of such vendors.

Nr. 55

Any "adequate margin of conservatism" should not imply that a margin is added to every parameter. Such an approach could add up to an enormous amount.

Nr. 61

It should be clarified that a regular communication of scenario calculations, especially concerning issues in the bullet points, is not required.