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The voice of banking & financial services

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Response to the Committee of European Banking Supervisors

CEBS Guidelines on the management of concentration risk under the supervisory review process (CP31)

The Association for Financial Markets in Europe (ĩAFMEö), the British BankersôAssociation (ĩBBAö) and the International Swaps and Derivatives Association (ĩISDAö) are pleased to respond to the consultation on the draft updated guidance on concentration risk.

Our key messages are in section 1. Section 2, contains detailed response on guidelines. We have not commented on all guidelines.

1 Key messages

The industry agrees with the importance of concentration risk measurement and management within an effective risk management framework.

Proportionality: We welcome the explicit recognition of the need for proportionality and that supervisors should explicitly take account of firmsô business strategies, models and the environment in which they operate. In particular it is very helpful to recognise that concentrations in a particular sector or geography etc, can also bring with it specialisation and expertise which can result in an overall higher quality portfolio. We strongly support the supervisory guidance that recommends that a balanced view must be taken. There are indeed risks inherent in óshoehorningô firms into entering a new line of business, customer segment or geographic location to obtain diversification, if it is an area where they have little experience or capability.

Level of application: As a Pillar 2 concept we continue to believe that concentration risk should be addressed at the consolidated level rather than solo. While concentration may exist at the solo level, concentration risks will tend to be managed at the group level and on an intra-risk basis feed back into the policies and procedures that support risk management. Therefore we urge supervisors to view firmsô activities and risks not just at the individual business lines, legal entity and geographical level but across the firm at a consolidated group level and balance concentration with, diversification. We acknowledge this is not an easy task particularly where national supervisors are operating at a local level, but would encourage CEBS to continue their efforts for supervisory convergence through the colleges and other cross-border co-operative initiatives between supervisors.

High level guidelines rather than check-lists: It is important that CEBS proposals remain relevant high level guidelines and principles which can be applied across firms but then suitably adjusted to the specific firm business model. With this in mind, we strongly support the principles based approach proposed rather than prescriptive ócheck-listsô that focus on regulatory expectations regarding good practice rather than defining best practice. In particular, our members are concerned the annexes are overly prescriptive as high level guidance and we recommend that they not be contained in the final guidance.

Implementation timetable: We note the implementation date for supervisors of 31 December 2010 and that the guideline indicates that flexibility should be given to firms to implement the changes necessary to comply on a phased basis. We strongly support such a phased implementation because the systems to capture and monitor data will take time to develop and test particularly given the significant number of regulatory initiatives currently underway. The guideline currently gives no indication as to the areas which are perceived to be priorities, and which firms should seek to address earlier, and which elements could be phased in later. We recognise that the processes that firms already have in place will have a bearing on this decision and look forward to dialogue with supervisors on this issue. We also support the proposal to conduct an implementation study after one year. This will enable CEBS to assess effectiveness and whether a level playing field is in operation.

Broader definition for concentration risk and inter-risk concentrations: We accept that concentration risk can be broader than the current definition under the Pillar 2 guidance. We also agree that the interaction between different risk types should be examined. However, modelling inter-risk concentration is complex and difficult to evaluate in quantitative manner. It is therefore important for supervisors to recognise the validity of a large array of approaches such as stress tests, scenario analysis backed by qualitative commentary and modelling. In doing so, supervisors should recognise that capital is not the only tool to address these risks as noted in the Guidance under paragraph 104. Capital can only mitigate against the effects of the once it materialises, rather than mitigate against the risk. As indicated in paragraph 104 a more appropriate supervisory focus is the risk mitigation process.

Supervisors should focus on regulation as a mitigant to concentration risk. In terms of capital and inline with Pillar 2 more generally, it is up to an individual firm to assess how much capital should be held against all the risks it firm faces, which will include concentration risk. There should be robust discussions between firms and their supervisors on the appropriateness of capital and liquidity buffers in relation to their concentration risk profile. If the capital provision is deemed inadequate and supervisory action is taken, particularly where this takes the form of an additional capital requirement, the assessment and rationale should be clearly set out.

Intra-risk concentration risk management: We would note that intra-risk concentration risk is not new, but a risk often managed as part of risk type procedures and processes, for example credit risk concentrations will feed into limit setting. It is important that this is borne in mind when supervisors review firmsôprocesses in light of the guidelines to ensure that the high level principles are applied intelligently. We would ask CEBS to acknowledge that it is not necessary to develop new policies and processes for concentration risk management where these are already embedded into the risk management procedures for particular risk types.

Stress-testing: Members would like to understand how these guidelines are supposed to interact with those on stress testing. We agree with Guideline 3 which notes stress testing is a key tool in the identification of concentration risk. Therefore we recommend paragraph 9 should also refer to the stress test principles outlined in CEBS CP 32. Complex chain reaction type events that involve the successive occurrence of contingent risks (for example liquidity), and second, third etc order events, that can only be addressed by way of stress and scenario testing, and sensitivity analysis. Stress tests should be done on a holistic basis looking at the risks being faced by the organization as a whole. While we agree with guideline 3, stress testing will identify concentrations, separate stress tests should not be run for a concentration risk.

Inter-dependencies with the forthcoming CEBS guidelines on capital allocation: We note that CEBS is preparing new guidelines on capital allocation that will cover the issue of diversification. It is important to consider these two issues together, as they are ôflip sidesôof the same coin. We therefore suggest including in guideline 7 a mention to the combined assessment of both concentration risk and diversification of the bank under the ICAAP. The phasing of implementation should take account the implementation timetable for the guidelines on capital allocation.

International Regulatory Convergence: The EU is home to a significant number of globally active financial services firms and we emphasise that a globally consistent regulatory approach will support the strengthening of global risk management practices. We would like to reiterate the need for global regulatory convergence and the importance of uniformity in the application of regulation.

EU supervisory architecture: CEBS will become the European Banking Authority (EBA) by the end of 2010. However, the legal status of CEBS guidance under the EBA is uncertain and there is a concern that these guidelines will become binding technical standards. We would like clarification of what the new supervisory arrangements will mean for CEBS proposed guidelines on concentration risk management and any other guidelines issued by CEBS before it becomes the EBA.

2 Detailed response to guidelines

Guideline 1

Firms wholly support the principle that concentration risk should be addressed in the governance and risk management frameworks of banks. Supervisors should allow for a range of approaches.

It should be noted that firms do not manage intra-risk concentration risk as a separate risk but integrate it into the policies, procedures of the various risk types. For example geographic or sectoral concentrations will be factored into limit setting for individual counterparties. We recommend the current wording in Guideline 1 is revised to reflect this point, as the current draft only focuses on providing a separate, stand alone approach to concentration risk management. We suggest that the draft be amended as follows:

Paragraph 19é .

In particular, institutions are expected to adequately address concentration risk in their governance and risk management frameworks, and where appropriate to assign clear responsibilities, and **where relevant incorporate into existing** risk policies and procedures the identification, measurement, management, monitoring and reporting of concentration risk.

Paragraph 22é

Concentration risk should be **adequately documented** in relevant risk policies, explaining how intra and inter ï risk concentrations are addressed at both group and solo levels. The risk management policy (ies) should be embedded in the risk management culture at all levels of the businessé ..

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

Guideline 3

We generally agree with the premise of this principle. However, Members seek greater clarity on the intent of paragraph 27. We would suggest that óassessô would be more appropriate than ópriceô

In paragraph 29, we welcome the suggestion that stress testing is key tool in the identification of concentration risk. This approach accords with the approaches being taken by the Basel Committee and UK Financial Services Authority on stress and scenario testing. However, we do not think it is appropriate to run specific concentration risk stress tests, because these should be done on a holistic basis looking at the risks being faced by the organisation as a whole. Stress testing will identify concentration but stress tests should not be run for a concentration risk.

Guideline 5

We agree that institutions should have adequate arrangements in place for actively controlling, monitoring and mitigating concentration risk and find the examples included useful. However, we are concerned by paragraph 35, which suggests that there should be top down and group-wide concentration risk limit structures. We would note that concentration risks are often incorporated within risk type processes and procedures and therefore may not be addressed in this manner; key risk indicators may be used as an early warning system, with reporting mechanisms to ensure risk committees undertake review.

Guideline 6

We generally support this principle. As regards intra-risk concentrations, we would note that reporting on these will be captured within existing management information produced and believe that additional specific concentration risk reporting should not be required.

Guideline 7

We agree that concentration risk should be taken into account in the ICAAP and capital planning. However, we think that the supporting text is confusing. These paragraphs seem to mix up the mitigants against concentration risk, for example buying credit protection, with the capital that should be held aside against concentration risks that can not be mitigated, i.e. providing a buffer against the effects of concentration risk once it has materialised.

A firmsô Pillar 2 process should have analysed whether concentrations have been sufficiently well mitigated (whether first or second order) so as not to require further capital underpinning. The guideline implies that concentration risk can be measured independently of the underlying risks involved and subjected to a separate capital charge. 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 ICAAP. The challenge facing banks is to identify risk concentrations which have not, as yet, been adequately addressed with the help of established models. These 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, i.e. qualitative, are appropriate.

Guideline 8

We support the principle in guideline 8. However, we seek further clarification on paragraph 51 and how it relates to the following paragraphs. Paragraphs 52 and 54 seem to relate to transaction structure and it would be helpful if these could be linked. We understand the regulatory desire in paragraph 55 but would note that, owing to the variability of available information, it will be necessary to accept that institutions will operate on a best efforts basis. We also note that this guideline overlaps with some of the requirements of the large exposures regime with respect to connected counterparties.

Guideline 10

We seek further clarity on how this guideline fits with the introduction of stressed VaR requirements in CRD 3. We also question whether Guideline 10 is suggesting that the liquidity horizon on all instruments should be extended by the same amount, as we think that a differentiated approach may also be appropriate.

Guideline 17

With regard to Risk Assessment Systems, we agree that qualitative comments are as important as the figures. Results should only be compared with an understanding of business models and discussions with management. If peer review is to be conducted and specific information sought from firms, it would be helpful to have clarity on any metrics to be used.

Guideline 18 and 19

With regard to supervisory assessment of a firms liquidity and capital provisions in relation to the unmitigated part of concentration risk, supervisors should focus on regulation as a mitigant to concentration risk. In terms of capital and inline with Pillar 2 more generally, it is up to an individual firm to assess how much capital should be held against all the risks it faces, which will include concentration risk.

Guideline 21

We agree with the guidance and in particular that a balanced view should be taken when assessing the focused activity by members that are, for example, private banks or institutions catering for particular sectors, such as charities, leisure, and development, and which have developed expertise to manage such bespoke services and risks. In such cases it is not necessarily beneficial to force diversification into areas that the institution does not have experience and therefore sufficient risk management capabilities.

3 Conclusion

If you have any comments or questions regarding this response please contact either, Diane Hilleard (diane.hilleard@afme.eu), Irving Henry, (irving.henry@bba.org.uk), and Antonio Corbi (acorbi@isda.org) should you require further information.

Yours sincerely,

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The Association for Financial Markets in Europe (AFME) represents a broad array of European and global participants in the wholesale financial markets, and its 197 members comprise all pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. AFME was formed on 1st November 2009 by the merger of the London Investment Banking Association and the European operations of the Securities Industry and Financial Markets Association.

The BBA is the leading association for the UK banking and financial services sector, speaking for over 200 banking members from 60 countries on the full range of UK or international banking issues and engaging with 35 associated professional firms. Collectively providing the full range of services, our member banks make up the world's largest international banking centre, operating some 150 million accounts and contributing £50 billion annually to the UK economy.

ISDA represents participants in the privately negotiated derivatives industry, and has over 810 member institutions from 57 countries on six continents. These members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities