Committee of European Banking Supervisors
CEBS

**Public hearing on CEBS draft revised Guidelines on aspects of the management of concentration risk under the supervisory review process (CP31)**

**Note of the meeting**

London, 12 March 2010

The Committee of European Banking Supervisors (CEBS) held a public hearing on 12 March 2010 to present its draft revised Guidelines on aspects of the management of concentration risk under the supervisory review process (CP31). The hearing was chaired by Nick Lock (Chair of the CEBS Pillar 2 Convergence Network).

Around 35 representatives from individual institutions, industry associations, consultancy agencies and journalists attended the hearing. There was constructive debate during the three hour session, within the context of broad support for the new guidelines, which led to several important points being raised for consideration by CEBS.

## Background

On 11 December 2009 CEBS published for consultation its draft revised Guidelines on aspects of the management of concentration risk under the supervisory review process[1], which are intended to update the Guidelines on technical aspects of the management of concentration risk under the supervisory review process published on 14 December 2006 and to complement the principles set out in the CEBS's Guidelines on the application of the supervisory review process (GL03)[2]

Building upon the lessons drawn from the financial crisis, CEBS's draft revised guidelines follow a holistic approach aimed at ensuring sound overall concentration risk management, under which institutions will be expected to identify and assess all aspects of concentration risk: this is significantly broader than the scope of the original guidelines, which relate mainly to credit risk concentrations.

[1] http://www.c-ebs.org/documents/Publications/Consultation-papers/2009/CP31/CP31.aspx
[2] http://www.c-ebs.org/getdoc/00ec6db3-bb41-467c-acb9-8e271f617675/GL03.aspx

CEBS believes that concentration risk may arise from connected factors which are not readily apparent and identifiable without the implementation of comprehensive processes to identify, manage, monitor and report concentration risk. It is essential for institutions to prevent concentrations from accumulating without these being properly identified and controlled, and for supervisors to be satisfied that this is happening.

Therefore, in the draft revised guidelines, CEBS is taking a broader approach to concentration risk management which states that it is not sufficient to analyse concentration risk only within a risk type (intra-risk analysis), but that analysis of concentration risk across risk types (inter-risk analysis) is also necessary - so including credit, market, operational and liquidity risk concentrations.

**General remarks**

In general, the draft revised guidelines were welcomed by attendees as they emphasised the importance of an integrated approach to concentration risk management, both within and between risk categories.

Some attendees requested clarification regarding the role of the guidelines in the light of proposed changes to the regulatory framework outlined in the recent BCBS publication[3] and EU Commission consultation paper on CRD IV[4], particularly in relation to the proposals for the new liquidity regulatory regime. CEBS responded that it is continually monitoring developments in the regulatory framework and will review if necessary, relevant aspects of the guidelines in order to make them consistent with any new regulatory regime, once proposals are finalised.

Attendees also stressed that the concentration risk ought to be considered alongside diversification, since diversification should be recognised as one way of managing concentration risk. However, there was agreement that certain concentrations might be inherent to the business model of a particular specialised institutions, and that diversification would not always be the best risk management alternative – especially if the diversification was into riskier business lines or into areas of limited management expertise. Some participants pointed out that the benefits of diversification might not be as high as anticipated, as was highlighted in the recent crisis when risk correlations tended to 1.

**Governance aspects**

A number of participants questioned whether the draft revised guidelines implied that concentration risk was a separate category of risk, and argued that, to a large extent, intra-risk concentrations were already covered by existing management and measurement approaches within the specific risk categories - for example credit risk concentration is already taken into account in management of credit risk and, in many cases, captured in the economic capital models. However, it was widely acknowledged that inter-risk concentrations should be also assessed, and that silo based approaches to risk management

[3] http://www.bis.org/press/p091217.htm
[4] http://ec.europa.eu/internal_market/consultations/docs/2010/crd4/consultation_paper_en.pdf

may overlook any build up of concentration across different risk types. Attendees agreed that concentration risk management should be seen as a part of the overall risk management architecture and framework of an institution, and it was therefore suggested that the guidelines clarify that there is not the intention to require the setting up of a special infrastructure, nor reporting lines, nor report formats and units to manage concentration risk, but rather that concentration risk management should be fully embedded into the overall risk management framework.

**Measurement and management aspects**

Many participants raised concerns over the direct link made in the draft revised guidelines between excessive concentration and potential capital add-ons. CEBS clarified that the aim of the draft guidelines was to improve institutions' overall risk management by reinforcing the need to address both intra- and inter-risk concentrations. The draft revised guidelines did not introduce any direct link between the level of concentration and the amount of capital required, but the remit of the respective supervisors and colleges of supervisors (starting from the application of CRD II in 2010) was to agree on the actual level of capital, including any capital add-on if deemed necessary. CEBS also stressed that, in the draft revised guidelines, CEBS does not indicate any preference as between risk mitigation or extra capital to cover the unmitigated portion of concentration risk; however, in understanding the effectiveness of any mitigation, institutions should be cautious about potential second round effects of such risk mitigation, e.g. mitigation of one risk type can create concentration in another (e.g. as occurred with reliance on bond insurance, which in turn created concentrated exposures to monoline bond insurers).

As for wider aspects of Pillar 2 capital, including add-ons, the aim of CEBS is to increase supervisory convergence and it is working towards this goal. It was noted that, in order to increase convergence of national approaches to the assessment of risks and evaluating the risk based capital adequacy of cross-border banking groups, CEBS is working on the new Guidelines for the joint assessment of the elements covered by the supervisory review and evaluation process and the joint decision regarding the capital adequacy of cross border groups[5].

Given that, for a number of participants, concentration risk and its management is not a separate discipline but rather a part of the overall risk management approach, they also pointed out that it would not always be possible to estimate the actual exposure to concentration risk nor to determine an explicit amount of capital specifically allocated to it. Rather, in such instances, the capital allocated to concentration risk would be included within in the overall risk capital total. They requested that the final text of the guidelines should provide enough flexibility to cater for this method of the implementation.

With respect to the identification of concentration risk, participants agreed that the stress testing is a key tool, especially for uncovering hidden concentrations. However CEBS was requested to clarify that supervisors would not be expected to undertake separate stress tests solely for the purposes of concentration risk

[5] http://www.c-ebs.org/documents/Publications/Consultation-papers/2010/CP39/CP39.aspx

management. Rather, it should be anticipated that aspects of concentration risk would be identified in the wider context of stress tests done for Pillar 2 purposes (e.g. as a part of firm-wide stress test as discussed in the CEBS's draft revised Guidelines on stress testing[6]).

**Specificities for cross-border banking groups**

Many participants drew CEBS's attention to the implications of the draft guidelines in the context of cross-border banking groups, where typically concentration risk would be identified and managed at the group level, rather than at entity level. The consequence could be some concentration within stand-alone legal entities in some specific products or sectors, but these concentrations would be mitigated by the group's overall risk management and diversification strategies. Although recognising that the guidelines are designed to be applicable to both cross-border groups and to stand-alone institutions, participants requested that the group perspective should be explored in more detail in the final text of the guidelines, and that the group perspective should be taken into account in supervisory considerations. In particular, participants were concerned that capital allocations and add-ons for concentrations at individual legal entity level could end up penalising the group diversification strategy.

Given the fact that concentration risk measurement and management, especially of inter-risk concentration, was still in its infancy, CEBS stressed the vital key importance of the ICAAP-SREP dialogue between institutions and supervisors, and that the college of supervisors would play an important role in such dialogue in case of a cross-border group. CEBS is separately reviewing the treatment of diversification, and will also address the topic in its forthcoming "Guidelines for the joint assessment of the elements covered by the supervisory review and evaluation process and the joint decision regarding the capital adequacy of cross border groups", where it will be highlighted as one of the elements to be considered by colleges in their joint assessment and decision.

**Specificities for smaller and regionally operating institutions**

Participants recognised that the draft revised guidelines addressed the issue of proportionality, and suggested that, in their supervisory review and evaluation, supervisors should take a balanced approach to the business models and activities of specialised institutions which may be concentrated, as a result of their business model, by customer type, specialised nature of product, or by funding source. They also requested that the final text of the guidelines should recognise that the geographical concentration of regional retail banks was not necessarily a significant risk (given their specialised local knowledge) and should explain the application of the principle of proportionality in relation to concentration risk management and supervisory review of such institutions.

Attendees at the hearing were encouraged to provide their written comments to the draft revised guidelines by 31 March 2010. All comments received would be published on CEBS's website unless respondents request otherwise. The final

[6] http://www.c-ebs.org/documents/Publications/Consultation-papers/2009/CP32/CP32.aspx

version of the document taking into account the results of the public consultation was expected to be ready by end of Q2 2010 and would be published on the CEBS's website.