



EUROPEAN SAVINGS BANKS GROUP
GROUPEMENT EUROPEEN DES CAISSES D'EPARGNE
EUROPÄISCHE SPARKASSENVEREINIGUNG

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European Savings Banks Group (ESBG)

Response to CEBS' guidelines on the implementation,
validation and assessment of Advanced Measurement
(AMA) and Internal Ratings Based (IRB) Approaches

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Profile European Savings Banks Group

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 €4,345 billion (1 January 2004). 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. For decades ESBG members reinvest responsibly in their region and are one distinct benchmark for corporate social responsibility activities throughout Europe and the world.



1. INTRODUCTION

The European Savings Banks Group (ESBG) appreciates the opportunity to comment on CEBS' proposed guidelines on the implementation, validation and assessment of advanced models (AMA and IRBA). Such guidelines are in principle useful for the industry, as they could clarify the expectations of the supervisors regarding the industry's use of advanced models. In addition, guidelines on these questions developed by CEBS could increase the convergence of supervisory practices across the EU.

The ESBG however believes that the Consultation Paper proposed by CEBS raises a number of questions which, if they are not addressed properly, would make it difficult to achieve the objectives pursued by CEBS (and shared by the industry). The main questions will be summarized in the first part of this document. The second part will consist of more detailed comments on the content of the proposed guidelines.

2. GENERAL REMARKS

Timing of the publication

The timing of publication of the paper is a major area of concern, as the document was published at a time when the process of validation of models was already well-advanced in a number of Member States, on the basis of instructions provided by the respective national supervisors. This concern related to the timing of publication is particularly accurate as regards the areas of CEBS' consultation paper which contradict the guidelines published at the national level.

The ESBG would like to provide one example to illustrate this concern: in section 3.3.1.2.2 on specialised lending (paragraph 172 and following), CEBS presents new aspects of the definition of specialised lending (compared to the Directive) and uses the sub-classes for specialised lending contained in the Basel II framework, as opposed to those defined in the CRD. Given that some supervisors have already published their guidelines on the basis of the framework set in the Directive, this approach might cause a substantial amount of extra efforts, resulting both from the proposed definition and from the proposed capital calculation for specialised lending.

"Status" of the paper

The problem mentioned in the previous section related to the timing of publication should be seen in combination with concerns regarding the status of the guidelines put forward by CEBS. By definition, guidelines drafted under the level 3 of the Lamfalussy process are not binding; they are addressed to the supervisors, which are free to use them in their implementation process at the national level. However, the proposed guidelines become mandatory if they are changed into mandatory regulation at the national level. The fact that the proposed guidelines are overly detailed and prescriptive creates the risk that the framework will become more burdensome, but not more efficient.

Against this background, clarification would be welcome as to which of the provisions of the paper are regarded by CEBS as binding, i.e. as having to be implemented by supervisors at the national level, as opposed to the provisions for which supervisors are granted room for



manoeuvre. In general, we are of the opinion that CEBS' consultation paper should be seen as providing examples to the national supervisors and the industry on how they can approach the issues addressed in the consultation paper.

Along the same lines, CEBS mentions in paragraph 23 of its consultation paper that "supervisors may impose stronger or more detailed requirements than those listed in the guidelines". However, if the paper is to be considered as providing non binding guidelines to the industry and the supervisors, it would be useful to mention that the supervisors can also impose "less strong or less detailed requirements".

Level playing field

As mentioned above, paragraph 23 states that supervisors may impose stronger requirements. This naturally raises concerns in terms of achieving a level playing field in the EU. To us, additional requirements should be imposed only in cases where this is necessary, on the basis of parameters such as the national culture and legal environment.

In addition, the cases where different requirements are imposed should be disclosed by the national supervisors. In this context as well, we would encourage CEBS to assess whether the stronger requirements imposed jeopardize the level playing field. The findings should be included in CEBS' report to the European Parliament.

Excessive level of detail

In general, ESBG Members regard the proposed guidelines as overly detailed. Our concern is that this could result in a sort of "tick-box" behaviour by the supervisors, instead of performing a valuable assessment of the IRB systems in order to determine whether they are conceptually sound and give appropriate results. Put differently, we see a risk of "remote control", in the sense that by publishing too detailed rules, the supervisors in fact end up running the bank; this should not be the role of supervisors.

- This concern can be illustrated by the guidelines provided by CEBS in the area of the credit risk control. More precisely, in Annex VII part 4 paragraph 128, the Directive lists the areas of responsibility for a credit risk control unit. In the guidelines provided by CEBS, a somewhat modified list is presented, which in practice results in less freedom for the institution in the organisation of its credit risk control (section 3.6.2 of the guidelines).
- Another example is provided by paragraph 377 of the guidelines, in which CEBS indicates that "the results of the CRCU's review should be reported to the management body (...) at least twice annually". A more "framework-orientated" guideline would be more appropriate in this context.

As a conclusion, in general, the ESBG would be in favour of more "framework-orientated" guidelines, complemented with relevant examples, especially when it comes to non-national topics, such as modelling and validation.

Excessive level of detail specifically in relation to "new" areas



It should be pointed out that a number of the issues addressed in CEBS' guidelines are new, and therefore both supervisors and the industry are still in a learning phase. As an example, there is no common understanding on how credit risk and risk parameters should be modelled. In this context, it would therefore not be appropriate for the supervisors to impose a set of detailed rules that would hinder the necessary development of new approaches.

- As an example, we could mention paragraph 219 of the consultation paper, where CEBS expresses one specific approach to model uncertainty. It should however be noted that modelling from other perspectives does create other ways to get hold of the uncertainty factor in default cases. Such an approach could be as appropriate as the approach put forward by CEBS.
- Paragraph 334 provides another example of the same concern. This section sets the principle of independent review in the validation process. However, the ESBG is of the opinion that this principle, which is difficult to achieve in practice, can be replaced by other approaches which provide equivalent results. In this context, it must be highlighted that the validation process requires personnel that are deeply involved in the details of the models. As such, to avoid duplication of resources and still comply with the general principle, some institutions prefer applying a “four-eyes” methodology, meaning that in each case at least two persons from the development team are involved in the process. In order to strengthen the validation processes, the “four-eyes” methodology is supported by strict internal validation rules.

Compliance with the Directive

The ESBG believes that in connection with a number of issues, the guidelines diverge from the EU framework. This is for example the case of paragraph 197 of the paper, where CEBS discusses the definition of default. In that section CEBS mentions the possibility to rate groups instead of legal entities (“e.g., if it is based on the consolidated balance sheet, and the ‘rated entity’ is thus the group”), as opposed to what is stated in Annex VII part 4 paragraph 23. Although we would welcome the opportunity to base ratings on consolidated figures as opposed to individual legal entities, we regard the divergence from the Directive as confusing.

Structure of the consultation paper

CP 10 covers a number of issues related to the Pillar 1 of the framework, such as the approval process and guidelines for the supervisors' assessment of minimum requirements for advanced internal models to control credit risk and operational risk.

The ESBG is of the opinion that the document would be clearer if it would follow a stricter structure. In our view, the document should be divided into three distinct parts: one section on the application process and the cooperation between supervisors, one section on the interpretation of minimum requirements for credit risk and one section covering the minimum requirements for operational risk. The section on credit risk could along those lines be divided into several subsections, namely: categorisation in exposure classes, model development, validation and internal governance.

Furthermore, additional work would be required to avoid the overlaps that currently exist between CP 10 and CEBS' consultation paper on cooperation between supervisors (CP 09).



3. SPECIFIC COMMENTS

Pre-application process (paragraphs 34, 37, 38)

CEBS' guidelines contain information about the new "pre-application process", which in essence prolongs the approval process as established by the CRD. This section should be structured further.

Paragraph 54

To us, the information contained in the points 2 and 8 is the same. In addition, we do not think that the information contained in point 5 brings light in terms of evaluating a rating system.

Paragraph 92 (transition period)

Paragraph 92 contains information in relation to the transition period and indicates that "preliminary applications cannot be considered formal applications at any time prior to the transposition of the CRD". In practical terms, this would result in a delay in the enforcement of the Directive.

Paragraph 101

The roll-out rules should be made publicly available and subject to convergence between Member States.

Paragraphs 134 and 140

In these sections, CEBS requires the parameters used for internal purposes and for capital requirements purposes to be "strictly in line". The ESBG is however of the opinion that this is difficult to achieve in practice, as the parameters used for regulatory purposes are more conservative, due to regulatory requirements, and in addition are not adequate for internal uses such as pricing, economic capital allocation, etc.

Section 3.3.1.1. – retail exposure class

Section 3.3.1.1 contains guidelines concerning the retail exposure class. Concerning the use test, the ESBG welcomes the flexible approach followed in paragraph 159 and would encourage CEBS to follow that approach throughout the section. Specifically, paragraph 159 indicates that "As long as an institution can demonstrate that any of these components differ clearly, this requirement can be regarded as met".

However, we are of the opinion that this statement is contradicted by the provision in paragraph 161, which states that "a company that is treated by an institution's sales management as a corporate because it is an important client should not be eligible for the retail exposure class (...)". We would strongly encourage a revision of paragraph 161 in a way that is consistent with the more general statement made in paragraph 159. In particular, we are of the opinion that there are material differences between risk management and sales management. This is notably due to the fact that as the banking activities are local, there might be good reasons to qualify a rather small client as important in the local market, even if the exposure features a rather low risk taken globally.



In paragraph 161, CEBS comments also on incentives for the institutions to adapt their risk management processes in order to fulfil the criterion in Article 86. In fact, the wording used in the CRD does provide the institutions with incentives to change their processes. As such, as long as processes are used as a basis for segmentation, such incentives will remain. The way to avoid such a situation is to focus strictly on the risks in the exposures and not on the processes.

Paragraph 182

Although we would agree with CEBS that the Basel II slotting criteria for specialised lending exposures are a good starting point, it should be noted that in many cases these criteria need to be developed further, given that as they currently stand they are vague and difficult to apply.

Section on preferential risk weights (paragraphs 185, 186, 187)

The approach proposed is overly prescriptive and could result in an excessive burden for institutions pretending to use preferential risk weights.

Paragraph 206

The proposed requirements would oblige institutions to collect information on “non-material” just as if they were material. The ESBG believes that whereas it is reasonable to expect a documented policy for the consideration of “materiality”, keeping track of these costs would represent an excessive burden.