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Betreft: NVB reaction 'CEBS Consultation technical aspects on diverisification under Pillar 2'

Dear Madam, Sir,

The Dutch Bankers' Association (NVB) welcomes the consultation of 'CEBS Consultation technical aspects on diversification under Pillar 2' since diversification of activities is a sound practice for a financial institution to run its business. The NVB 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 on-going dialogue is the essential part of the Supervisory Review & Evaluation Process (SREP), especially for the modeling of diversification under Pillar 2.

In this regard the NVB would like to emphasize that the establishment of 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**.

General Comments
In general the NVB supports the CEBS technical aspects and believes that it is a step in the right direction for modeling diversification under Pillar 2. However, the NVB is of the opinion that:

- The 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 NVB 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.

  In addition, we would like to add that an adequate reflection of the risk is not necessarily conservative. The NVB firmly believes that if a regulator does have a more conservative view regarding the framework of risk diversification under Pillar 2, the regulator can apply an add-on to the total capital level but should not distort the capital calculation of the institution itself.

- 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. The NVB strongly believes that transferability should therefore not be treated as a part of the technical aspects of diversification. If CEBS would like to maintain this section in this paper the NVB suggests 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 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), where diversification between different risk types, also known as inter risk diversification, is covered under Pillar 2. The insurance industry recognizes the following split[1]: (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. The NVB suggests to make a clear distinction between different types of risk diversification in section '6.3. Addressing the risk types'.

- 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. The NVB pleads to adjust the words 'stable

[1] Diversification technical paper, Groupe consultatif actuariel European, October 2005.

and/or stability' in 'robust and/or robustness' of correlation estimates throughout the consultation paper.

- 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'.

Specific Comments

- The NVB appreciates the view of CEBS in Paragraph 17: 'Risk factors that have a significant influence on the risk profile of an institution, and therefore on its internal capital estimates, should be identified and included in the model'. In the on-going dialogue with supervisor, an institution can illustrate which risks are relevant for their business. Therefore the NVB believes that non-relevant risk types may not be per se the supervisory argument to lower the diversification benefits.

- Section 1.3 (Paragraph 20 - 23) and Section 3 refers to conservative risk margins. As stated in the general comments, the methodology to calculate the adequate capital under Pillar 2 is amongst others based on the risk appetite of an institution. If a supervisor doubts if the parameters are conservative enough it cannot be solved by applying more 'prudent' parameters. This hinders the insight and may provide a false sign of correctness.

- The NVB wonders if section 1.4 (Paragraph 24 - 28) and section 2.3 (Paragraph 44 - 48) do have added value. Since, any model used is internally reviewed by the validation unit if the model complies with well-defined criteria (such as completeness and robustness). It is at the onus of the company to prove that (whether or not they have developed their own model or have purchased one).

- Paragraph 36 refers to the identification of potential or existing data quality. The NVB misses in this context the quality of the position data of the portfolio.

- The NVB would like to stress that the use of correlation matrices for defining diversification effects does solely apply for the calculation of diversification effects of market risk (paragraph 38).

- Paragraph 40, third bullet '… the correlation estimates are reasonably stable over time'. The NVB suggest to replace the wording 'reasonably stable' with 'robust' as in changing circumstances should normally be reflected in changing correlation estimates.

- Paragraph 49 states that 'in cases of expert based estimates (….), the key issue is how the risks associated with the subjectivity of expert-based techniques are addressed and controlled'. Given the fact that due to lack of data some models / correlations (e.g. operational risk correlations) have to be expert opinion-based, the NVB would appreciate if more supervisory guidelines can be provided on this issue, since the paper focuses mainly on statistical approaches which are generally well-known.

- Paragraph 52 states that 'the robustness, stability and conservatism of the methodology adopted by the institution are among the key issues of interest to supervisors when looking into capital models'. The NVB suggests to delete the word 'stability'; if market conditions alter strongly this will have an effect on the strategic decisions and therefore on the methodology. The NVB also suggests to delete the word 'conservatism; an adequate reflection of the risk is not necessarily conservative. If a firm wants to be conservative, it is better to make this conservatism explicit by holding an additional capital buffer (like many firms do) than to 'hide' these conservative assumptions by using conservative model parameters in deeper layers of the capital model.

- Paragraph 55 states that 'supervisors may want to pay attention to ensuring that an adequate margin of conservatism is embedded in the estimates'. The NVB reiterates that an adequate reflection of the risk is not necessarily conservative. Furthermore, aligned with the chosen risk appetite, diversification effects 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 a skewed risk / return analyses.

- The NVB would like to ask CEBS to be more specific on the issues in the sections '3.2 Stress Testing' and '3.3 Sensitivity Analysis'.

- The NVB would like to underline that in practice the validation process of an internal model is applied to the model as a whole and does not specifically validate the accuracy and robustness of the diversification parameters as is suggested in Section 4 paragraph 63.

- In addition to paragraph 68 / 69 the NVB would like to emphasize that:
    - although back testing have been proved to be useful for model validation, that a next crises will most likely behave differently;
    - data collection for back testing the loss distribution of tail events, which happens once in 1000 years, is not very realistic; and
    - in practice back testing is useful for the market risk of the trading book, where data are available on a daily basis. Back testing of other risk types, where data are not available that frequently is deemed to be very rough to justify 99.9% estimates on its own.

- The NVB misses in paragraph 78 the fact that the risk appetite chosen by the senior management plays is key in the ICAAP. The NVB would suggest adding the important role of the chosen risk appetite of a financial institution.

- Paragraph 81 states that 'one of the key issues for supervisors is to ensure that the estimation of diversification effects is <u>not detached</u> from the internal management process'. In this regard, the NVB reiterates that the risk appetite of a financial institution is a core consideration in the strategic planning process, which explicitly <u>attached</u> the estimation of diversification effect to the internal management process.

- Paragraph 84 states that 'in order to better understand and address diversification effects, the comparison of internal capital calculations and Pillar 1 minimum capital calculations could often provide useful information and are a possible tool to consider'. The NVB agrees comparison of Pillar 1 and Pillar 2 calculations of capital can provide useful information but this is already an ICAAP requirement.

- Paragraph 87 states that 'since diversification is obviously not the only factor resulting in differences between internal and Pillar 1 capital numbers, it is important for supervisors to determine precisely the drivers influencing the internal calculation'. The NVB believes that this determination is relevant and valuable, but also very time-consuming. Therefore the NVB believes that such a determination should done on a high level in first instance, and requested in detail on an economic basis.

- Paragraph 89 states that 'documentation of differences between internal and Pillar 1 capital numbers would be useful for the comparison'. The NVB asks CEBS to be more specific what CEBS desires from the industry. The NVB would suggest to compare the capital numbers when the model is designed and further with a maximum frequency of once year once the model has been taken in production.

With kind regards,

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