

14 December 2006

**Feedback to the consultation on**  
**'Technical aspects of the management of Concentration risk**  
**under the supervisory review-CP11 - 2<sup>nd</sup> part'**

**Introduction**

1. In March 2006, CEBS published a consultation paper on 'Technical aspects of the management of interest rate risk arising from non-trading activities and concentration risk under the supervisory review process-CP11'. These guidelines aimed at providing some technical follow-up with regard to two risks that both supervisors and institutions need to address within Pillar 2.
2. The Consultation period ended on 23 June. All responses (11) submitted were published on the CEBS website.
3. This feedback document summarises the key points raised in these comments and highlights the changes CEBS has made in response to them with regard to Concentration risk<sup>1</sup>.
4. The final guidelines on 'technical aspects of the management of concentration risk under the supervisory review process' are now being published. A table setting out in more detail the comments made and CEBS' response to them is contained in this document.
5. The responses criticised the level of prescriptiveness and details of the guidelines. In that respect, CEBS believes that the technical guidelines on Concentration risk are sufficiently high-level and principles-based to be adopted by supervisors in a proportionate and risk-based manner.
6. The need of guidelines on Concentration risk was questioned in the responses. According to the industry
  - a. CEBS has already published comprehensive guidelines on Pillar 2 (GL03),
  - b. there are no 'best practices' in the industry. Therefore CEBS runs the risk of hampering the further development of 'best practice' with guidelines which are too detailed and over-prescriptive,

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<sup>1</sup> Final guidelines on IRRBB has been published on [www.c-eps.org](http://www.c-eps.org)

- c. CP11 does not clearly articulate the objective, nor assess whether extra regulation is really required to achieve this objective,
  - d. in relation to the timing: there is no need to have technical guidelines on Pillar 2 Concentration risk, yet.
7. With regard to point (a), CEBS considers it necessary to set out the range of approaches supervisors already mentioned in GL03 in the context of a particular risk which is not fully captured by Pillar 1. This is to promote convergence in supervisory practices and consistency in application of Pillar 2, for the interest of both supervisors and market participants. It is also necessary to have those guidelines in place when the CRD enters into force.
  8. With regard to point (b), the draft guidelines were further discussed to reflect the key findings of the CEBS survey of industry practices<sup>2</sup>. Moreover, with regard to Concentration 3, it was noted that for institutions using economic capital models, concentration risk is not necessarily taken into account as a separate component but is rather modelled implicitly under a wider risk assessment. Therefore the terms 'thresholds or similar concepts' have been used to reflect this situation.
  9. Moreover, CEBS wishes to reiterate that in relation to the Pillar 2 Supervisory Review Process, and Concentration risk in particular, it is the full responsibility of the institution to choose, apply, and monitor their internal methodologies for risk assessment and management. The approach of institutions to managing their concentration risk does not lend itself to prescription and is therefore rightly a matter for the dialogue under Pillar 2 SRP.
  10. With regard to point (c) the objective of the present guidelines has been clarified upfront along the line of para 7 above.
  11. With regard to point (d), some of the market participants indicated that the issue of Concentration risk should be addressed in the overall on-going review of the large exposures regime, and therefore the finalisation of the guidelines should be postponed until the large exposure review is completed.

CEBS recognised that there is common ground between 'large exposures' and concentration risk: the current large exposures regime is designed to limit the ability of institutions to over-commit themselves to individual borrowers. However, if institutions have a high proportion of individual large exposures this represents a form of concentration risk. Therefore, it is noted that the guidelines will be revisited, where relevant, in light of the outcome of such review.

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<sup>2</sup> Available at [http://www.c-eps.org/Advice/LE\\_industryreport.pdf](http://www.c-eps.org/Advice/LE_industryreport.pdf).



### CEBS' analysis of responses to CP11- Concentration risk

Text CP11 (Cross reference to the related paragraph)	Received Comments (summarised)	CEBS Analysis	New text (Cross reference to the amended paragraph) N/R=change not required
<b>General remarks</b>			
	<p>The specifications go significantly beyond the CRD: Art 123 and Appendix V only contain brief specifications with regard to concentration risks and require only that they are addressed and managed by means of written regulations and procedures</p>	<p>CEBS considers that:</p> <ul style="list-style-type: none"> <li>• concentration risk is one of the most important risks which institutions are expected to address within Pillar 2. They should have appropriate systems within their ICAAPs to measure, monitor and control risk concentrations, whether they relate to individual counterparties, products, sectors or geographic region. They are also expected to consider if capital should be allocated to mitigate that risk.</li> <li>• The guidance set out in CP11 is compatible with the CRD. It articulates in broad terms what supervisors expect of institutions and how they will review and evaluate concentration risk within Pillar 2.</li> </ul>	N/R

		Institutions have considerable flexibility in demonstrating how they meet these guidelines in practice.	
	<p>CEBS refers primarily to the corresponding recommendations of the Basel Committee on concentration risks, which are directed only to internationally operating banks.</p> <p>CR is a management issue that should be tailored to the risk profile, the risk appetite and the business of the bank.</p>	The recommendations of the Basel Committee are relevant to both internationally active and only nationally active institutions. Naturally the proportionality principle in Pillar 2 also applies to concentration risk. This has been clarified in the guidelines.	<p>Para 7 and 19 state:</p> <p>'The concept of proportionality, as laid down in the provisions of the Directive 2006/48/EC related to Pillar 2 and underlined in the introductory statements of CEBS' guidelines on the application of the supervisory review process, applies also to Concentration risk measurement and management, the complexity of which will be expected to be related to the size of the institutions as well as to the sophistication and diversification of their activities.'</p>
	<p>CP11 guidance is too detailed.</p> <p>There is a risk to hamper the developments / improvements of internal models. Institutions should be given the flexibility and freedom of action within a</p>	<p>CEBS considers that CP11 is framed sufficiently broadly granting institutions considerable freedom and flexibility in meeting the guidelines.</p> <p>However, CEBS has reviewed the current guidelines to clarify them where necessary,</p>	N/R

	<p>set of principles that guarantee a certain quality of standard.</p> <p>Another respondent however recognised that CEBS has taken a more principles-based approach, notably with regard to C1-C5. It emphasises that the application of principles should be risk-based and not a box-ticking exercise.</p>	<p>notably in relation to Concentration 2.</p> <p>CEBS acknowledges that institutions are developing new advanced quantitative techniques to measure their concentration risk. CEBS welcomes and encourages this work. However, it does not consider that its guidelines, as currently framed, establish rigid supervisory requirements which hamper the further development of risk management techniques.</p> <p>CEBS fully accepts that supervisors should avoid a box-ticking approach, and that materiality and proportionality are key considerations for supervisors and institutions alike.</p>	<p>See new para 6</p> <p>This is emphasised in para11</p>
	<p>The opportunities arising from the diversification of risks, which must lead to corresponding capital benefits are not sufficiently addressed.</p> <p>The additional effort and expense incurred for more intensive / improved risk recording must be accompanied by easing the pressure on the capital ratio and it must be recognised that in diversified portfolios a lower level of monitoring with regard to the CR is necessary and justifiable. Diversification can also be considered as a mitigation techniques.</p>	<p>CEBS CP11 is predicated on the understanding that the Basel framework has already been calibrated on the basis of a well diversified bank. So while it may be possible in a limited number of cases to claim 'super' diversification, the focus of CEBS guidelines is on concentration risk.</p> <p>Institutions that make use of more sophisticated economic capital models, in general, take into account diversification and concentration effects indirectly by their correlation modelling.</p> <p>On the other hand, the stock take of industry practices regarding large exposures demonstrated that there is a significant heterogeneity of approaches used to measure and to treat diversification effects. Some of the institutions are themselves at an initial stage of development.</p>	<p>N/R</p>

		In that respect, CEBS recognises that further work on both sides is necessary to better understand diversification effects in pillar 2.	
	Agree that, as set out in Concentration 9, stress testing is a very useful way to reveal risk concentration.  Suggest treating all aspects of stress testing together in CP12.	The Consultation period for CP12 is now over. CEBS is currently processing the responses received. CEBS has indicated in its work programme its intention to build a guidebook that will encompass and interrelate all the guidelines.	
	Comparison between banks should be avoided as they are misleading. On the contrary, ad hoc analyses, multi-criteria approaches, stress testing should be developed and directed toward decision making: soft limit setting, hedging, mitigating, selling etc. Pragmatic and judgmental approach should prevail.	CEBS broadly agrees but considers that peer group comparison and benchmarking is nevertheless a useful tool to enable supervisors to compare and contrast the various individual approaches taken by institutions.	N/R
<b>Concentration 2</b>	<b>Institutions should have appropriate internal systems or methods to identify and measure concentration risk which are suitable to the nature, scale and complexity of their business<sup>3</sup>.</b>		
	Whenever policies on CR are being determined, this is done at the top consolidated level and not at the level of legal entities: legal entities such as some kind of SPVs may have a high CR but at a group level this kind of concentration is meaningless / non significant.	Agreed. However, such policies should take into account the concentration risk of each entity as well as the overall picture of the concentration risk within the group	N/R
	Guidance on concentration must not prevent nor hinder institutions to commence or to continue specialised activities or activities within a specific sector, because an institution may also be fully diversified within a specialised activity or a specific sector.	CEBS acknowledges the observation, and notes that the guidelines seek to reflect the point in the section relating to specialist institutions.	N/R

<sup>3</sup> This is the principle that was consulted upon. Please refer to the final guidelines for the definitive wording.

	Doubt whether it is appropriate to measure CR along the same principles as those for credit risk:-the very existence of any CR will depend on the definition of the reference pool such as internal sector or geographic region. How should these reference pools be defined to ensure level playing field without being over prescriptive? The respondent does not agree that this reference pool should be determined by regulation.	It is not the intention of CEBS to seek to prescribe categories of concentration risk. CP11 has the status of guidelines and institutions can choose their own definitions. These will be discussed as part of the dialogue under the SRP.	N/R
	C2 requests the existence of internal systems that combine several categories of CR as well as CRM techniques. This does not correspond to the actual design of institutions; risk management systems which are not yet capable of connecting impact of CRM with exposures to CR.	From the industry practices report, it seems like the most sophisticated models consider CRM techniques. However, some institutions seem to use models that are not able to capture directly mitigation effects.  However, CEBS considers that its guidelines are compatible with both sound risk management practices and the overarching requirements of Directive 2006/48/EC.	N/R
<b>Concentration 3</b>	<b>Institutions should apply appropriate limit structures for concentration risk in relation to their overall risk appetite and/or profile<sup>4</sup>.</b>		
	CEBS should not provide too many examples. C 3 applies to some banks but is not applicable to others and this might render the dialogue with their supervisors more difficult. 'Limits' should be mutually discussed by banks and supervisors, without a specific check list as the CP seems to suggest.	The examples provided are meant to be illustrative – supervisors should not apply a ticking-box approach. This will be addressed through the Pillar 2 dialogue under the SRP.	See para 11
	'Limits' should take into consideration the specificities of Specialised banks or banks with local business which by nature are already limited on business.	This point is addressed in the section relating to specialist institutions.	N/R

<sup>4</sup> This is the principle that was consulted upon. Please refer to the final guidelines for the definitive wording.

	<p>'Limit' is misleading. Institutions define maximum concentrations of risk acceptable to them. Suggest using 'areas of concern'. Would welcome clarification on whether the figures of these areas of concern should be measured nominally or should be risk-weighted.</p> <p>The list of para 36 should be extended to include an index that takes into account the contribution to a portfolio's concentration made by a large corporation or a geo-sectoral cluster. Such indices could also be used to calculate the regulatory capital buffer envisaged in C5.</p> <p>The limit setting process should take into account CR analysis based on both qualitative and quantitative indicators. There must be enough flexibility to express internal credit risk limits with the appropriate metric(s). These metrics should be well understood within the institution.</p>	<p>The CEBS report says that internal limits are one of the most used tools to manage single-name concentration risk.</p> <p>They often differentiate between soft and hard limits, though. Soft limits may be breached subject to specific circumstances and management approval.</p> <p>It is also noted that in economic capital models, concentration risk is not necessarily taken into account as a separate component but is rather modeled implicitly under a wider risk assessment. Therefore the terms 'thresholds or similar concepts' have been used to reflect this situation.</p> <p>This could be one approach but CEBS would prefer to discuss this as part of the supervisory dialogue under Pillar 2 and not attempt to create exhaustive lists.</p> <p>Agreed. This will be part of the supervisory dialogue under Pillar 2.</p>	<p><b>Concentration 3 now reads:</b> Institutions should use internal limits, thresholds or similar concepts, as appropriate, having regard to their overall risk management and measurement.</p> <p>This Change was consistently applied in the whole document, wherever necessary.</p>
<p><b>Concentration 4</b></p>	<p><b>Institutions should have adequate arrangements in place for actively monitoring, managing and mitigating concentration risk against agreed policies and limits<sup>5</sup>.</b></p>		
	<p>Concentration may appear in many forms and may differ depending on the definition of the reference pool and other features.</p> <p>The following examples may illustrate this:</p>	<p>It is not intended that the guidelines should be applied rigidly. The opportunity to discuss the appropriateness of different approaches will be afforded through the dialogue under Pillar 2 of the SRP.</p>	<p>N/R</p>

<sup>5</sup> This is the principle that was consulted upon. Please refer to the final guidelines for the definitive wording.



	<p>1) A bancassurance group could take into account insurance policies in order to reduce exposures for credit risk. One does not support an approach according to which the mitigation for CR would (partly) be reversed by a capital supplement under Pillar II when it is provided by the insurance entity of the group.</p> <p>2) Imagine a regional mortgage bank with a client mortgage portfolio being situated along the banks of a major river. Does the risk of this river flooding over imply a CR for this bank?</p>		
	<p>One respondent did not agree with the proposal that new business acquisitions may be adjusted in order to cope with undue concentrations.</p>	<p>This seems to be a misunderstanding by the respondent of the sentence 'reviewing approval levels for new business'. This has nothing to do with mergers and acquisitions but relates to internal levels of approval of (lending) operations with new clients.</p>	<p>N/R</p>
<b>Concentration 5</b>	<b>Institutions should assess the amount of internal capital which they consider to be adequate to hold against the level of concentration risk in their portfolio<sup>6</sup></b>		
	<p>In measuring the internal capital, the CR is implicitly taken into account, but is not accounted for separately. There is no need for establishing any additional capital under Pillar 2 to cover this risk or to distinguish it in the reporting.</p>	<p>CEBS accepts this proposition. However, it is up to the institution to explain and demonstrate how concentration risk is taken into account in the measurement of internal capital. As indicated in GL03, any regulatory capital requirement under Pillar 2 would have to be considered on the basis of an overall assessment taking into account individual risks. As a result of this overall assessment, and if relevant, supervisors have at hands a wide range of</p>	<p>N/R</p>

<sup>6</sup> This is the principle that was consulted upon. Please refer to the final guidelines for the definitive wording.

		supervisory measures. One of those measures is a capital add-on.	
<b>Concentration 8 and 9</b>	<b>Supervisors will use quantitative indicators within their Risk Assessment Systems to assess degrees of concentration risk. The supervisory review should encompass both the qualitative and organisational aspects of concentration risk management<sup>7</sup>.</b>		
	<p>Too many examples. Proposed indicators can be misleading. Banks should therefore identify on an individual basis specific sectors that are particularly sensitive to them and which should consequently be in the focus of the SRP.</p> <p>There is a danger that requirements and principles governing the fundamental criteria of the supervisors' models calibrated for a certain type of banks could be used to monitor CR for other types of banks. Advocate a more flexible approach, taking into account the specificities of individual banks and not interfering with their internal models and strategies.</p> <p>As a second alternative, supervisors should be required to inform banks in detail of the methodologies used for evaluation and the threshold values (absolute and relative) above which CR will be judged as high. Since the assessment of CR is part of the broader SRP, it would be helpful if evaluation parameters differ from the current ones, that these are notified immediately to the banks, to get their consent and if necessary, prompt adaptation.</p>	CEBS agrees that it is the responsibility of senior management of the institutions to determine the categories of concentration risk which are relevant to their own businesses. The examples provided are for purposes of illustration.	The paragraph explaining Concentration 8 has been shortened and clarified: it now reads: 'Supervisors can build up these indicators based on the set of limits, thresholds or similar concepts defined internally by institutions (see Concentration 3). They may also develop their own models and tools such as indicators based on the existing regular reporting from institutions, including the reporting of large exposures or geographical / sectoral risks against regulatory capital'
	One respondent did not agree that supervisors should use 'qualitative' requirements such as management's expertise. What would be the criteria to assess this expertise? It is much more important that CR be	CEBS general guidelines under Pillar 2 refer to supervisors considering both quantitative and qualitative factors having a bearing on the overall supervisory assessment of institutions.	N/R

<sup>7</sup> This is the principle that was consulted upon. Please refer to the final guidelines for the definitive wording.

	detected in quantitative terms and that the most suitable techniques to mitigate them are used.		
	Oppose to any standard or systematic business or geographical breakdown of their portfolio. CR analysis must be tailored to the characteristics of the portfolio and to the anticipated deterioration of certain industries or countries to be precisely delineated. It is a dynamic process, changing over time, focused on decision making.	<p>Supervision is always a dynamic process. Static regional or industry sectors make sense to have a first contact with the portfolio of the bank and also for comparative reasons. But a deeper analysis needs to be put in the context of the bank activity.</p> <p>It should be the responsibility of the institution to use a breakdown that best suits its specific portfolio.</p> <p>Supervisors should (in general) not prescribe the use of a specific breakdown for internal use by institutions (although the latter may sometimes be necessary e.g. in cases where institutions clearly lack sufficient monitoring tools).</p> <p>However, in order to facilitate supervisors in their overall assessment of financial stability and in order for them to gain a first insight into the degree of concentration at different institutions, the use of a standardised breakdown may be of great help but as the industry rightly mentions, it does have its drawbacks. In practice a standardised breakdown may be easier to work with (and/or less costly) than monitoring information based on each institution's internally used breakdown. Moreover, using a standardised breakdown may help to preserve a level playing field. However, it must be noted that, given the drawbacks of standardisation, indications of concentration risk based on such a standardised breakdown should preferably be verified against an institution's internal systems before any</p>	N/R

		definitive supervisory measures are taken. Also, the use of a standardised breakdown does not relieve institutions of applying further refinements and adjustments to their internally used breakdown when required in the context of their own concentration risk profile.	
Para 14 on mitigation of concentration risk	Add risk-adjusted pricing which takes account of exposure concentration as well. In this way, in order to take on a new exposure with a large group in which the bank has already a CR, or any new exposure in a geo-sectoral cluster where it is concentrated, the capital charge would be higher than on a risk with the same PD and LGD but not concentrated.	Point taken.	N/R
Para 12-13(i) on industry practices	There is no unique indicator of risk concentration. Do not include examples. The indicators and the techniques must be appropriate and commensurate to the bank risk profile.	CEBS considers that the use of examples is helpful in broadly illustrating the various approaches which industry is taking. CEBS is keen to be informed by industry good practices and in that respect, has carried out and published a survey of industry practices in the context of the Commission's LE review.  The key findings of the CEBS survey have been taken into consideration when finalising the guidelines	See among others new para 13 to 17, 19,21,22