BNP PARIBAS

BNP Paribas Position note

CEBS Consultation Paper 31 on the Management of Concentration Risk under the Supervisory Review Process

The Committee of European Banking Supervisors intends to issue guidelines regarding concentration risk management under the Supervisory Review Process. These guidelines are to be applied by Dec. 31st 2010.

In this context, the CEBS has published on December 11 th 2009 a consultation paper on the draft guidelines and is expecting comments no later than March 31st 2010.

This consultation paper deals with the following four items:

- Definition of concentration risk,
- General considerations and principles for concentration risk management,
- Management and supervision of concentration risk within individual risk areas, and
- Supervisory review and assessment.

BNP Paribas welcomes the opportunity to respond to the consultation on the draft guidance on the management of concentration risk under the supervisory review process.

BNP Paribas's response to the consultation paper 31 on concentration risk completes the responses sent by the European Banking Federation (EBF) and the French Banking Federation (FBF).

The present position note draws out in Section 1 some general comments regarding the CP 31. Section 2 contains further detailed comments on the guidelines.

1. General comments

Definition of concentration risk

While we support guidance that risk management / measurement should take into account concentrations and their impact, we would like to emphasis that concentration should not be viewed or defined as a new risk type, but rather as a specific way to consider a given risk.

Moreover, concentration is generally a second order effect that needs to be put in perspective with primary risk drivers such as the likelihood of occurrence and the severity. Hence, 'concentration risk' should not be separately analyzed from the primary risk factors.

For instance, in credit risk analysis, the measure of concentration is purely conventional as there is no benchmark for determining what qualifies as 'unconcentrated' level for a portfolio.

As there is no stand-alone exposure to concentration risk, but only concentration in certain risk exposures, the concept of gross/net exposure to concentration risk has no meaning.

Trying to reduce concentrations is only beneficial if it does not lead to higher overall portfolio risks (and this is not always possible in some concentrated markets such as financial institutions).

Accordingly,, we consider that ambiguity on ‘concentration risk’ terminology exists in the CEBS consultative paper. Therefore we suggest clarifying the wording for concentration risk in the consultation paper. We highlight that concentration should not be viewed as a distinct risk category but rather acknowledged it as a part of a firms overall risk management framework. A clear guideline on concentration risk definition is the cornerstone for implementing well-targeted, feasible and appropriate requirements for concentration risk management.

Concentration and Systemic risk

Concentration risk, as described in the CEBS draft principles, includes several distinct topics that need to be addressed in different ways, including notably:

- Elements of systemic risk that are the remit of macro-prudential supervision rather than risk management at each bank level, and
- Complex chain-reaction type of events that involve the successive occurrence of contingent risks (e.g. liquidity risk) that can essentially be addressed through scenario analysis and stress-testing.

Systemic crises arise from the fact, among others, that all the financial institutions have comparable behaviours when managing their risks. Some concentrations are intrinsically linked / consubstantial to usual banking activities and that become a threat only in case of systemic crisis.

As systemic risk refers to macro-prudential concerns, we consider that it cannot be addressed via micro-prudential measures. Therefore we consider that it is neither realistic nor relevant to require financial institutions to manage systemic risk.

Hence, we suggest systemic risk be explicitly excluded from the concentration risk scope.

Measurement of concentration risk

We would like to stress that many existing risk management activities within financial institutions already take into account concentration, albeit not labelling it as such.

However, the guidelines should acknowledge that the measurement of risk concentrations, especially those arising across risk types (i.e. inter-risk concentrations), is very difficult to achieve through robust, reliable and proven quantitative techniques.

While we do not challenge that the interactions between different risk types should be examined, we find that CP 31 denotes unrealistic expectations in this regard. Therefore, we consider that a focus on quantitative modelling approach may in some instances prove counterproductive as it would necessary rely on illusory assumptions.

Consequently, supervisors should acknowledge the validity of a wide array of approaches such as stress tests, scenario analysis backed by experts' judgement, qualitative analysis and, when possible, modelling.

Scope of application (solo vs. consolidated levels)

Concentration risk should be normally addressed at consolidated level for large banking groups, as material concentrations only appear at group level. Concentrations at solo level are essentially driven by legal entities specific businesses and locations along with local economies' intrinsic concentrations, and are largely irrelevant as they diversify at group level.

Further, concentration risk should be assessed relative to the institution's markets intrinsic concentrations and relative to peers.

Concentration and diversification, link with capital and articulation with regulatory framework

As they are two sides of the same coin, concentration and diversification should be assessed jointly. Considering that concentration and diversification are intimately interlinked, a well-diversified structure makes an institution more resilient and should be favoured as a good risk management practice.

Consequently, there should not be a specific layer of capital for concentration risk and concentrations should not trigger additional capital in a mechanistic manner.

Moreover, BNP Paribas's ICAAP already accounts for concentrations (e.g. through economic capital models). Contemplate additional capital charge for concentrations would result in double-counting.

Concentration and reporting

BNP Paribas acknowledges the need for adequate internal reporting and appreciates the flexibility offered to institutions: principles-based reporting and design of own reporting methods).

2. Specific comments

Guideline 1 – The general risk management framework of an institution should clearly address concentration risk and its management.

- *Article 19 – 20*

  We would like that guidelines clarify that institutions will not be required to set up specific policies, procedures or governance for concentrations if these are already addressed in their risk management frameworks.

- *Article 22*

  As aforementioned, we would also like that guidelines recognise that material concentrations should be primarily addressed at group level as local concentrations generally diversify away. This topic could be addressed during the Supervisory Committee of the group in order for host regulators to have the required level of comfort on the management of concentrations.

Guideline 2 – In order to adequately manage concentration risk, institutions should have an integrated approach for looking at all aspects of concentration risk within and across risk categories (intra- and inter-risk concentration).

- *Article 24*

  See "Concept of inter-risk concentration" in Section 1 "General comments" as well as the response to article 22.

- *Article 25*

  The second order effect described in this article is unclear. One can see possible overlap with the measures envisaged in BCBS 164 regarding wrong-way risk. The second order effect should be either clarified or abandoned.

Guideline 3 – Institutions should have a framework for the identification of intra- and inter-risk concentrations.

- *Article 26*

  We would like to reiterate that there is no risk drivers associated with concentration risk as, like already mentioned, concentration is not a risk in itself, but a feature of the primary risks.

- *Article 27*

  This article is fairly general and unclear as it suggests integrating detailed-enough analyses of potential evolutions of financial markets and economic conditions in a forward looking approach to concentration risk.

  Thus, mentioning in the same article the importance of risk-adjusted pricing and the need for a forward looking dimension in concentration management is confusing.

- *Article 28*

  In this article, BNP Paribas suggests that the expression in brackets "*(at both group and solo levels)*" be withdrawn.

Guideline 4 – Institutions should have a framework for the measurement of intra- and inter-risk concentrations. Such measurement should adequately capture the interdependencies between exposures.

- *Article 31*

  Instead of "quantify" BNPP would prefer a more appropriate verb, such as "assess", in order to take into account the potential difficulty to quantify. Hence, the article would be as follows:

  > *"The measurement framework should enable the institution to evaluate and **assess** the impact of risk concentrations on its earnings/profitability, solvency, liquidity position and compliance with regulatory requirements in a reliable and timely manner…"*

  Moreover, BNP Paribas would like CEBS to add an article or a paragraph recognizing that some aspects of concentration risk (especially inter- risk concentration) are intrinsically difficult to quantify and that experts' judgment should consequently apply.

Guideline 5 – Institutions should have adequate arrangements in place for actively controlling, monitoring and mitigating concentration risk.

Controlling, monitoring and mitigating concentration risk should be part of the risk assessment in any institution. Many banks like BNP Paribas have already put in place limits and thresholds / alerts systems.

However BNP Paribas considers that formal limit structures are no panacea and should not be a substitute for management's judgment. Accordingly, we would like that guidelines require institutions to set up formal limit structures only for cases considered as appropriate by the institutions,,allowing the use other types of tools such as thresholds or regular monitoring of key indicators.

Hence, in article 35, the expression "where appropriate" should be added:

> *"An institution should set, **where appropriate**, top-down and group-wide concentration risk limit structures (including appropriate sub-limits across business units and across risk types) for exposures to counterparties or groups of related counterparties, sectors or industries, as well as exposures to specific products or markets."*

Guideline 6 – Institutions should have adequate arrangements in place for reporting concentration risk. These arrangements should ensure the timely, accurate and comprehensive provision of appropriate information to management and the management body about levels of concentration risk.

- *Article 43*

  The guidance of CEBS on reporting of concentration risk is welcome as long as it is principle-based and allows for banks to define their own reporting methods.

  As already mentioned it is neither appropriate nor efficient to require reporting at solo and consolidated levels. The consolidated level should be the priority.

  More fundamentally, putting together a reporting for concentration risk is conceptually difficult to understand as concentrations are not independent from their underlying risks. Concentration risk is a sub-product of a set of risks that are individually modeled.

  With regard to mitigating actions that have to be undertaken, the guidelines should clarify that not all concentrations should trigger mitigative actions, if these concentrations are consistent with the bank's risk appetite.

- *Article 44*

  BNP Paribas wants to outline that that the requirement on the frequency of the reporting "should reflect the nature of the risk drivers, especially with regard to their volatility" might be not be relevant when the driver is not material and/or the dynamics of a set of risk drivers are not correlated.

Guideline 7&20 – Institutions should ensure that concentration risk is taken into account adequately within their ICAAP and capital planning frameworks. In particular, they should assess, where relevant, the amount of capital which they consider to be adequate to hold given the level of concentration risk in their portfolios.

Supervisors should assess whether concentration risk is adequately captured in firm-wide stress testing programmes.

As mentioned earlier, we strongly oppose the view that institutions should hold "capital for concentration risk". Concentrations are one element already considered in the ICAAP, along with diversification and risks not included in pillar 1. Based on the comparison of the overall ICAAP result against pillar 1 capital requirements it should determined whether additional capital is required.

- *Article 46 & 110*

  As concentration and diversification are interlinked, concentration is taken into account in the ICAAP. The concentration is captured as a sub-product by the treatment of the other risks in the ICAAP process.

  Concentration risks should be one output, among others, of the stress testing process. Within the stress testing process concentrations should be assessed from the overall perspective of the banking group, together with the portfolio structure and its diversification characteristics.

- *Article 47*

  Proposing to measure net and gross exposures to concentration risk does not make sense as concentration risk can not be isolated from the primary risks.

  Measuring net concentration risk, after taking into account mitigants is unrealistic, especially because many mitigating factors are not quantifiable.

- *Article 48*

  BNP Paribas firmly opposes the possibility, left open by the guideline, to have a dedicated capital charge for concentration, which would be based on a measurement of the concentration performed independently from the measurement of the underlying risks.

Guideline 8 – Institutions should employ methodologies and tools to systematically identify their overall exposure to credit risk with regard to a particular customer, product, industry or geographic location.

- *Article 52*

  It should be noted that many of these elements will be addressed in Pillar 1 when BCBS 164 will come into force.

Guideline 9 – The models and indicators used by institutions to measure credit concentration risk should adequately capture the nature of the interdependencies between exposures.

As mentioned earlier, we question the terminology of ‘concentration risk’ and suggest the title of this guideline be modified as follows:

From *"The models and indicators used by institutions to measure **credit concentration risk** should adequately capture the nature of the interdependencies between exposures."*

To *"The models and indicators used by institutions to measure **credit risk** should adequately capture **concentrations**."*

Guideline 10 – An institution’s assessment of concentration risk should incorporate the potential effect of changing liquidity horizons.

No particular remark.

Guideline 11 – Institutions should clearly understand all aspects of OPRC in relation to their business activities.

- *Article 73*

  It is very unlikely that high frequency/medium impact (HFMI) loss events would jeopardize the survival of an institution as they would trigger corrective measures before doing so.

Guideline 12 – Institutions should use appropriate tools to assess their exposure to OPRC.

No particular remark.

Guideline 13 – In order to be able to identify all major kinds of liquidity risk concentrations, institutions need to have a good understanding of their funding structure and be fully aware of all underlying influencing factors over time. When relevant, depending on its business model, an institution should be aware of the vulnerabilities stemming form its funding structure, e.g. the proportions of retail and wholesale funding. Also, when relevant, the identification of liquidity risk concentrations should include an analysis of geographic specificities. Finally, the identification of concentrations in liquidity risk should take into consideration off-balance sheet commitments.

No particular remark.

Guideline 14 – In identifying their exposure to funding concentration risk institutions should actively monitor their funding sources. A comprehensive analysis of all factors that could trigger a significant sudden withdrawal of funds or deterioration in their access to funding should be performed.

No particular remark.

Guideline 15 – The qualitative assessments of concentrations in liquidity risk should be complemented by quantitative indicators for determining the level of liquidity risk concentration.

No particular remark.

Guideline 16 – Institutions should take into account liquidity risk concentrations when setting up contingency funding plans.

No particular remark.

Guideline 17 – Supervisors should assess whether concentration risk is adequately captured in the institution's risk management framework. The supervisory review should encompass the quantitative, qualitative and organisational aspects of concentration risk management.

No particular remark.

Guideline 18 – In cases where supervisory assessment reveals material deficiencies, supervisors, if deemed necessary, should take appropriate actions and/or measures set out in the Article 136 of the CRD.

No particular remark.

Guideline 19 – *Supervisors should assess whether institutions are adequately capitalised and have appropriate liquidity buffers in relation to their concentration risk profile, focusing on buffers (liquidity and capital) in relation to the unmitigated part of any concentration risk.*

We refer to our response to Guideline 7. It is not clear how supervisors will assess whether capital held by the institution adequately covers the nature and the level of concentration risk. Depending on the regulators a differentiated assessment could be performed among countries, potentially jeopardizing the common level playing field within the industry.

Guideline 21 – *Supervisors should pay particular attention to those institutions which are highly concentrated, e. g. by customer type, specialised nature of product or funding source.*

No particular remark.

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