Nederlandse Vereniging van Banken

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CEBS
via email: cp31@c-ebs.org
CC: Mr. Arnoud Vossen

Date March 31, 2010
Reference BR1106\5

Subject: NVB reaction to CEBS Consultation on the management of Concentration Risk under the SREP process

Dear Sir, Madam,

The Netherlands Bankers' Association[1] (NVB) welcomes the opportunity to comment on the CEBS consultation paper 31 on '*aspects of the management of concentration risk under the supervisory review process*'.

We agree with the main line of thought that is presented in the paper; banks should be aware of concentration risks in their portfolios and set up systems to monitor and manage these risks. We therefore welcome the opportunity to comment on this very important topic.

As the pillar one calculations assume perfectly diversified portfolios, banks should monitor and manage concentration risks as part of their ICAAP process under pillar II. As a result, guidance on the management of concentration risk should not be too descriptive, as this would contradict with the firm specific approach of pillar II. A bank should set up a system to manage concentration risk according to its own assessment of what is required to manage these risks properly. Subsequently, the adopted approach has to be discussed with the regulator during the SREP process. The institution will have to satisfy the regulator that its policies, procedures and systems are effective for managing concentration risk.

We feel that managing concentration risk should consist of the following steps:
1. Measure Concentrations
2. Gain knowledge about the concentration risks in your portfolios
3. Act upon the gained knowledge

The result of this three step exercise should be that capital add-ons for concentration risks are calculated and are added to the capital requirements under pillar two. The same concept applies to diversification benefits; here capital requirements are decreased according to the observed benefits.

[1] The Nederlandse Vereniging van Banken (NVB) is the representative voice of the Dutch banking community with over 90 member firms, large and small, domestic and international, carrying out business in the Dutch market and overseas. The NVB strives towards a strong, healthy and internationally competitive banking industry in the Netherlands, whilst working towards wider single market aims in Europe.

Looking at the requirements with regard to concentration risk, we note that the following processes are already in place:

i. Managing concentrations by geography, sector and product type
ii. Adhere to the large exposures regulatory requirements
iii. Complement these two items with a high quality stress tests[2]

Aggregation of the various concentration risk measures
At this moment banks are working hard to integrate the management of concentration risk that is done for the different risk types such as credit- market- and operational risk, into a holistic approach. As a starting point, banks should manage concentration risks within each risk type; extending the scope to a firm wide view is the ultimate goal. Moving to one holistic framework should be done when the institution is able to manage the concentration risks that occur in each of the risk types separately. Therefore, the process to manage and measure concentration risk should be introduced in a number of consecutive stages. The use of stress tests can be a helpful tool in achieving this goal. We appreciate that CEBS also recognizes this concern in the consultative paper, by stating '*Therefore, CEBS recommends that the implementation of the guidelines can be phased, and - whenever necessary - national supervisors provide the institutions with sufficient flexibility regarding the implementation of specific aspects of the guidelines.'* in paragraph 12.

Solo vs. Consolidated basis
At several points in the document, both solo- and consolidated reporting is mentioned. With regard to monitoring concentration risk on a solo level, we question the added value of this requirement. Small branches can have relatively large concentrations that do not form a concentration on the group level if they are guaranteed by the group. In such cases, managing concentrations on the solo level does not make sense. On the other hand, we also note the prudential requirements that could exist on a solo level. Where these requirements are present, these should be addressed in the SREP dialogue as well as in the college of supervisors. The college should also contribute to a consistent implementation of the supervision of how banks manage concentration risks.

Level of descriptiveness
In certain areas, the consultative document is very descriptive. We are pleased to learn from conversations we had with our regulator that the guidance should be regarded as examples of how the implementation of the guidelines could look, but that it should be based on the individual characteristics of each bank. This underlines the relevance of managing concentration risk under pillar two, an approach which we endorse.

This concludes our general points of feedback. For our detailed remarks, please see the appendix. In case you have any questions based on our feedback, please feel free to contact me at your convenience.

Kind regards,

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Advisor Risk Management

[2] Please also see the NVB reaction on stress testing (CP32) ref BR1108.

Appendix - Detailed remarks

Point 16 on page four states that: "*For example, an institution highly dependent for its profits on a single business sector and/or a single geographic area may be affected to a greater extent by sectoral or regional business cycles. Different sources of income may not be independent of each other. These interdependencies should be taken into account when assessing concentration risk."* This text refers to business risk, which is typically influenced by the investment decisions that are made by senior management. As such, business risk cannot be influenced by risk management. Institutions that are in the final stages of implementing a firm wide concentration risk management system should include business risk as part of the firm wide elements. Business risk should be measured and managed on the group level of the institution.

We agree with Guideline 1: '*The general risk management framework of an institution should clearly address concentration risk and its management.*'

We feel that the suggestions put forward in 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).*' and Guideline 3 '*Institutions should have a framework for the identification of intra- and inter-risk concentrations.*' are quite academic, lack practical relevance and focus too much on calculations. Risks should in our view be managed primarily by people and not only by models. This principle should be reflected in the consultative paper. As models are a simplified representation of reality, people will always be more versatile in spotting 'out of the box' links, developments, possibilities for contagion, etc.

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.*' addresses intra- and inter risk concentrations. We would like to point out that the consecutive approach should apply here as well. This approach starts by looking at concentrations per risk type and subsequently takes firm wide concentrations into account as and when an institution is able to monitor these firm wide concentrations.

We agree with guideline 5: '*Institutions should have adequate arrangements in place for actively controlling, monitoring and mitigating concentration risk.*' The fact that words like 'for example' are used underlines the institution-specific orientation that concentration risk management should have.

With regard to 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.*' we note that reporting concentration risks can be quite tough to establish. Especially if the requirement is to create a holistic view, this can be hard to achieve. In our opinion, banks themselves should steer the way they shape their concentration risk management. Subsequently, the institution should convince the regulator that the adopted approach fits the organisation and meets all the prudential requirements.

We agree with Guideline 7: '*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.*'

Looking at the elements that are mentioned in paragraph 50, we note that all these elements are already included in the management of concentration risk. For instance in the large exposures regime, the monitoring of geographical-, product- and sectoral concentrations, stress tests, etc. The objective of these measures is to find out what the second order effects of concentration are, so that these can be acted upon by the institution.

In response to 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.*' we note the three step approach we introduced on page 2. In our view this approach will properly address concentration risk.

In paragraph 52, it is mentioned that inter obligor relationships can be complex. We agree with this statement and welcome the acknowledgement that this can be burdensome to execute.

Although Guideline 9: '*The models and indicators used by institutions to measure credit concentration risk should adequately capture the nature of the interdependencies between exposures.*' is true, models and indicators need to be complemented by competent risk managers in order to be effective. With regard to models, the PD, EAD and LDG models are regularly validated and monitored for performance. In terms of regulatory capital, there are caps and floors that make sure that excesses cannot occur. Full diversification models, however, are much harder to assess for effectiveness, both in terms of quality of the model as well as understanding the results.