LIBA

LONDON INVESTMENT BANKING ASSOCIATION
6 Frederick's Place
London, EC2R 8BT
Telephone: 44 (20) 7796 3606
Facsimile: 44 (20) 7796 4345
e-mail: liba@liba.org.uk
website: www.liba.org.uk

The voice of banking & financial services
British Bankers' Association
Pinners Hall
105-108 Old Broad Street
London EC2N1EX
T +44(0)20 7216 8800
F +44(0)20 7216 8811
E info@bba.org.uk
W www.bba.org.uk

ISDA

International Swaps and
Derivatives Association, Inc.
One Bishops Square
London, E1 6AD
Telephone: 44 (0)20 3088 3573
Facsimile: 44 (0)20 3088 3555
website: www.isda.org

Joint Trade Associations' response to: CEBS CP20 "Technical Aspects of Diversification under Pillar 2"

The UK industry welcomes the CEBS paper as an important step for discussing diversification matters with regulators. For globally active financial groups diversification offers an extremely important risk mitigant by balancing diverse geographically and/or business activities as well as operations which generate robust and sustainable profit streams. In this context our Members believe that any dialogue on diversification effects should be informed by a rigorous review of the ways in which Internal Capital Models are *used* within a firm.

We view the CEBS consultation paper as an indication that European regulators recognise the strategic importance of diversification, and that they are prepared to recognise both intra-and inter-risk diversification within their assessment of a firm's overall risk profile under Basel II Pillar 2. We furthermore agree with the principal statements of the paper that diversification measurement and management and economic capital models are closely interlinked, and that assessing one necessarily leads to assessing the other. We also strongly agree with the repeated statement that the ICAAP is to be seen as a firm's internal rather than regulatory driven process.

However, it would be helpful if the paper also explains its relation to similar work done by the Basel Committee on Banking Supervision (BCBS) (i.e. the current consultation paper on "Range of practices and issues in economic capital modelling") and other industry initiatives on Pillar 2.

The paper in principle provides a sound template on which firms and their supervisors can and should shape their engagement and detailed discussions on the issue of diversification. The issues raised in the paper give European financial groups some indication about the direction of forthcoming Pillar 2 discussions with their supervisors and to this end is helpful. Though in this regard, our Members urge CEBS to provide more direction to supervisors on how to take a pragmatic and realistic approach in applying these guidelines. We therefore like to offer the following comments.

General Comments

Roles for economic capital models

Overall, we seek further clarity from the supervisory community in terms of their expectations in assessing internal capital models. In particular we seek to understand the way in which firms' model output is used in the Pillar 2 assessment framework. It is important to recall that at present, internal capital models have multiple uses within a firm: pricing, resource allocation, risk-adjusted performance metric (RAPM) and so on, and for many if not all of these purposes, accuracy is much more important for a bank's internal capital management than the conservatism inherent in regulatory capital, as banks are seeking to establish a realistic and proper view of risk. More, specifically it is felt that any added value of safety buffers would distort the true picture of risk that is

vital for a firm's business plan. These models are not, for example, analogous to the "Pillar 1" models such as Value at Risk in the Trading Book or the Internal Ratings models for which firms have to obtain supervisory approval subject to specific criteria and parameters. The internal capital models, by contrast, are designed by the firm to assist the management of the firm and it is important that this key function is not distorted. In future, should Pillar 1 charges ever become based on internal models then many of the apparent assumptions, expectations and requirements that seem in places to be embedded within the CEBS draft guidelines would be appropriate. So while we welcome CEBS's recognition of diversification as an integral part of prudent risk modelling practices, we caution against the use of an overly prescriptive supervisory approach towards firms' internal economic capital models. Furthermore, as a general stance, we do not favour Pillar 2 capital add-ons, but believe that the Pillar 2 capital assessment should be performed on a holistic basis looking at governance and risk controls as well as capital plans

Conservatism

Diversification is to be encouraged as a risk management tool as a contributor to internal best practices, and we do not therefore endorse guidelines or rules that do not enable firms to express diversification effects adequately in internal models. The CP and its Annex make several references to the notion of "conservatism" in internal capital estimates (Introduction ¶5; §1, ¶13; §3.1, ¶55; Q13, Q23). The spirit of these paragraphs and questions appears to be that it is expected or understood that firms will adopt a conservative approach to the estimation of correlation (in particular). As pointed out above, this approach appears in contradiction with the mere objective of firms' economic capital of being accurate and reflecting the economical view, and not the more conservative regulatory view.

For example, we do not agree that "conservatism" should be expected in internal capital model estimation in the same way it is expected in Pillar 1 models. Financial firms feel that the "74 questions" and the preceding paragraphs may represent an unduly onerous burden, which places emphasis not just on diversification effects, but on internal capital modelling in general, and moreover focuses, in our opinion, too much on detailed technical questions rather than on diversification understanding and management within a banking group.

We agree that assessing robustness of a model (for example, stability of correlation assumptions), examining stress scenarios and similar activities are all an important part of addressing model risks. However, our Members feel that the apparent suggestion that the day-to-day uses of the internal capital model should be based on inherently conservative assumptions may discourage the use of diversification as a tool of risk management. Furthermore, if firms use internal capital models for the purposes outlined above, then rather than compete on best estimates of risk profile – embodying the risk profile of the specific firm – firms will implicitly compete on levels of conservatism.

Thus, we suggest that it is possible to conduct internal capital analysis on the basis of conservative assumptions in the name of capital adequacy, but that in performing risk measurement for the other purposes outlined above (i.e. where a capital model is designed and operated for a firm's clearly established own needs and purposes) above there should be no such presumption in a SREP-ICAAP dialogue.

More consideration needed

In terms of developing this important dialogue and furthering the understanding of diversification, we feel that the paper is silent on several important aspects of the supervisory assessment of diversification, while being overly prescriptive and going into excessive detail on others. The most significant amongst these aspects are:

1. The divergent approaches by regulators, where some supervisors allow Pillar 2 to be based on internally developed Economic Capital models, while others require that the Pillar 1 results

form the basis, to which risks not covered in Pillar 1 have to be added. It would be helpful if the CEBS paper could address this in order to achieve regulatory convergence.

2. Most firms manage their risk categories on a "silo" basis (intra-risk diversification) and assess diversification across risk categories (inter-risk diversification) in a second step. Intra- and inter-risk economic capital models tend to be driven by quite different model assumptions and data sources. The paper does not make a distinction between these categories of economic capital models and their respective challenges, nor does it acknowledge the specific issues related to different intra-risk models. We would welcome a paper and questionnaire structure that clearly distinguishes between

    - Issues related to inter-risk diversification
    - Issues related to intra-risk diversification models for all risk categories
    - Issues specifically related to intra credit risk diversification

3. The sheer number of possible regulatory questions at the end of the paper appears onerous and overly detailed for meaningful supervisory discussions of the subject, if, for example all the questions were to be issued to a firm. We would propose that, to enhance utility, the questionnaire is reduced in scope to fewer, overarching themes that, moreover, take into account the above mentioned structure of intra- versus inter-risk diversification. The questions could for instance be refocused and ordered by risk themes, i.e. market, credit and operational risk. Additionally, it should be clarified if the questions address all risk models or only inter/intra-risk ones.

4. Finally, it should be emphasised to supervisors that the questions are to be seen as a menu for regulators to choose from as is appropriate. It should be emphasised very clearly that the supervisor must be pragmatic and realistic in relation to its objectives and the type of model(s) when selecting the question.

The CP seems to address much broader issues, better contained in a CP on topics for discussion in a firm's ICAAP. For example, §5 and §7 are general discussion points likely to emerge in the ICAAP-SREP dialogue, but seem misplaced in a CP on "Technical Aspects of Diversification under Pillar 2". Any meaningful alteration in the ICAAP-SREP dialogue should be subject to considerable consultation and debate. We feel, quite strongly, that unless we understand the proposed and planned status of Internal Models in relation to the ICAAP and SREP, we cannot form views on the relevance/appropriateness of supervisory expectations vis à vis Economic Capital Models.

According to the Capital Requirements Directive, an economic capital requirement has to be calculated, in the context of Pillar 2 requirements, for each legal entity. The paper mentions the group supervision issues, but does not tackle the different allocation methodologies. The technical guidelines should address this important and difficult issue.

Internal capital models are a means by which differences in firm diversification profiles (and hence risk profiles) are expressed, and hence a vehicle for diversification effects to be encouraged within a firm and therefore across the financial industry via the normal process of competition.

Finally, in terms of supervision, the paper's scope puts a stronger weight on host supervisor's involvement in Pillar 2 supervision. Given the nature of diversification and the fact that its modelling is only meaningful on group level, the leadership of the home supervisor in this process needs to be emphasised in the document to manage expectations.

Appendix – Further Detailed Comments on individual items in CP20

On a technical level we have some comments – which we would like to point out, do not outweigh our overall positive view on the paper. For example, we have identified a number of misleading or incorrect statements regarding, i.e. the methodology of modern portfolio modelling (§5, §15f, §38f,§55).

The paper, moreover, introduces a number of regulatory measures or requirements which are overly prescriptive and go beyond the CRD. We have outlined all the technical comments in this appendix but would like to point out the following issues of concern:

- The level of documentation requirements for internal models (§15); in particular compared to vendor models (§25). We urge CEBS to provide guidance on an appropriate level of documentation to ensure a level playing field across Europe. Given the historical cataloguing of alterations to internal capital models (some have been around for nearly 20 years which makes retrospective cataloguing impossible) it would make sense to only focus on "material" changes (where materiality can be defined using principles);
- Requirements for model validation and other data analyses (§15, §19, §67ff) which are unsuitable for models which base on sparse data;
- Burdensome additional analysis requirements (§56ff, §59ff, §61, §87);
- Indirectly raising capital requirements by suggesting that institutions will have to "claim" diversification benefits (§67);
- Unrealistic governance requirements with respect to division of labour (§66) and senior management / board involvement (§76f, §82);
- Transferability of financial resources within a group (§100).

Introduction

- *§5: Supervisors are particularly interested in the demonstration of the stability of an institution's diversification framework in the context of its economic capital model, especially under stressed conditions.*

Economic Capital models measure loss potential under stressed conditions. Are supervisors interested in meta-stresses? A correlation model may or may not allow correlation relationships to vary – it is a question of model specification. For example, it is possible to conceive of a copula or Var/Covar framework itself being subject to alteration in responses to a kind of regime shift. This is not just semantics – it is reasonable for firms to consider correlation breakdown, and in particular to be aware that correlation assumptions derived from time series may not represent, for example, differing monetary policy regimes.

- *§6: Apart from the general dialogue with the industry, the current paper could be used as a tool for the institution specific ICAAP-SREP dialogue.*

Pillar II is designed as a "firm driven process" starting with a firm's ICAAP report, being reviewed and challenged by regulators. The consultation document and its annex seem to reverse this order and pre-determine a rather quantitative review process, albeit that the paper emphasises that the questions presented are merely options that a supervisor may use.

- *§6: In the annex, a list of possible questions on diversification models is provided. Keeping in mind that the ICAAP is a firm driven process, these questions are intended to assist supervisors in their assessment<…>.*

Although regulators acknowledge the “firm driven process”, these types of lists are designed to be used, in the one or other way and therefore contradict the overall Basel II concept.

Chapter 1 - General overview of the capital model

1.1 Methodology and documentation

There appear to be high documentation standards set in this section. Theses standards should be specified to apply only where they are material and make sense. It should not become too burdensome and nor should excessive documentation become a condition for the recognition of diversification (§§ 11, 14 and 15.)

- *§12: Diversification assumptions are already included in the current Basel II framework. For instance, the IRB approach is based on the assumption of an infinitely ("asymptotically") diversified portfolio.*

We acknowledge that the IRB approach is indeed based on the assumption of a diversified portfolio. However, while it is therefore technically correct to state that diversification assumptions are already included in the capital adequacy framework, it is of course not possible within the architecture of Pillar 1 for a firm to gain any benefit for the actual diversification (or indeed penalisation due to concentration) of its portfolio or between different categories of risk. Hence, the meaningful recognition of diversification is extremely limited and is in fact implicit within the calibration of the IRB charge, as opposed to being a factor that can be adjusted according to an individual firm’s profile.

- *§13: The use of a model exposes the institution to so-called "model risk", i.e. the risk that models are not sufficiently representative of reality, that they are applied to tasks for which they are inappropriate or are otherwise implemented incorrectly. Therefore, this type of risk is generally taken into account in the development of the methodology by the means of conservative margins, sensitivity analysis or stress testing for instance <…>.*

This paragraph is not clear in that Model Risk as defined in this § conflicts with Operational Risk. Model Risk is 'omnipresent' throughout the document and this § list various causes of Model Risk and stresses its importance. It would therefore be helpful to clarify its definition in the paper.

- *§15: The following minimum information is generally considered to be available as a part of the model documentation:*
  <...>

  ~ The basic assumptions of the model and the results of the tests as regards the adequacy (i.e. well founded and observable) of these assumptions (the basic idea is to highlight an overestimation or underestimation bias);

Testing the adequacy of results with respect to 99.95%-iles and beyond becomes highly subjective and difficult for risks with sparse data.

~ The reasons for the various choices made during the model’s development and an estimate of their impact on the precision of the model (e.g. the modelling technique, length of the observation period, factor loadings of the data, exclusion of certain risk factors or business units, etc);

~ A history of the modifications made to the system, mentioning the impact of the modifications on the results from the model; and

We believe any reasonable firm would track material changes. We suggest the debate here focuses on the definition of "material." We reiterate our view that the "72 Questions" are a useful guide for internal model challenge – but we stress that retrospective detail is largely unobtainable. In particular we note that some institutions have been developing their internal capital models for over 15 years. For these firms a documentation of all options weighed and choices made during this process would be impractical. It is therefore important to avoid any highly prescriptive and burdensome documentation requirements.

~ the methodology and the scenarios used for crisis simulations.

It is unclear to some of our members what is meant here as the main purpose of Economic Capital models is to simulate and understand the impact of crisis situations. Internal models cover liquidity risks, IRB and so on. In these contexts, we feel a supervisor would be compelled to ask a firm how crisis situations are derived, and modelled.

1.2 Scope

This section insists on the completeness of the various risk factors that should be considered within a capital framework. Even if that can impact the estimation of correlation, this is a pre-requisite of capital models that are out of the scope of this analysis. (§ 2). In the same context, they do not question problems linked to time horizon and confidence interval discrepancies when aggregating risks.

- *§16: it is particularly important to ensure compatibility between various models or an integrated approach to the risk measures.*

At this stage and for the foreseeable future, models differ significantly by risk type due to differing risk drivers and portfolio levels they apply to (e.g., interest rates vs. operational risk event types; transaction level vs. portfolio level). Compatibility can only be required for models employing identical risk drivers and allocation levels. Risk type integration is generally very awkwardly done. We feel supervisors and firms may wish to develop a principles-based approach, and we reiterate our belief that the financial industry may wish to set up a suitable forum to develop views on best practices.

Chapter 2 - Diversification parameters

2.1 Data / time series availability and quality

Again, there is a lot of emphasis here on model risk and more precisely on model risk stemming from diversification parameters. The focus of the section is also on the way diversification parameters can be estimated: statistical vs. expert judgement. The paper stresses the fact that the risk profile of the institution should be considered whatever the process chosen and also the importance of adequately documenting and explaining shortcuts and approximations used. The main focus appears to be exclusively on statistical methods, but nothing is said about expert judgment approaches.

2.2 Correlations

This section considers that the most common technique for defining diversification is the use of correlation matrices. If the guidelines were to be interpreted by supervisors as meaning that correlation matrices were the only valid technique this would be restrictive as in some firms other

forms of diversification are considered i.e. the netting effects that occur between banking and insurance activities through the ALM risk. We would appreciate greater clarity of drafting on this point to avoid an unduly restrictive outcome.

Again, no distinction is made between intra and inter diversification/correlations. We find that intra diversification is most of the time far more important than inter diversification.

- *§38: The terms "correlation" and "diversification parameter" are generally used interchangeably, reflecting the fact that currently the most common technique for defining diversification effects is the use of correlation matrices.*

There is misleading terminology here as the key issue in this context is how correlation is modelled. In particular, it needs to carefully distinguish among which quantities (e.g., interest rates, counterparty defaults, or events) correlations are measured or estimated. Also, we do not agree that a "parameter" can be thought of as synonymous with an entire correlation framework.

- *§39: <...> a significant change in the risk profile, business strategy or risk appetite of an institution will be likely reflected in the correlation parameters.*

In a proper model this should not happen as correlations should describe dependency of the underlying risk drivers and not the portfolio under investigation (we see a similar issue in the second bullet of §40).

Chapter 3 - Reliability and conservatism of the methodology

3.1 Robustness, stability and conservatism

- *§53 - as far as robustness is concerned, one of the main areas <.....> to sudden changes in the economic cycle.*

Incorporating current and foreseeable market conditions in the estimation of diversification benefits would be extremely subjective and would also necessitate similar levels of evidence and argumentation to demonstrate that the diversification benefits are not distorted [see statistical vs. expert based estimates (2.4)]. From a practical standpoint, this would be difficult to quantify and subsequently defend. Additionally, the ability to react promptly to changes in the economic cycle via amendments to the diversification benefit would only be possible if the forward looking estimates sufficiently capture the actual market conditions observed. We do acknowledge, however, the limitations of relying on backward looking evidence as a predictor for future events.

Where Internal Models are used for pricing and RAPM, they are used on the basis of best estimates of relatively near term projected environments (or indeed the past). For capital adequacy analysis, and where risk appetite is defined over performance in a future stress, it is to be expected that forward looking models are also used. These are two separate uses and our Members feel strongly that regulators acknowledge this dual purpose.

Conservatism is presented as one of the key issues of interest to supervisors when looking into capital models. As we have discussed earlier in our paper, firms design capital models for a range of purposes and conservatism is not necessarily compatible with the firms' use of economic capital models. (§ 52.)

The CP states that the estimation process should reflect current and foreseeable market conditions and provide forward-looking estimates of the diversification benefits, resulting in prompt reaction to sudden changes in the economic cycle. This appears to be a challenging requirement as firms are not able to forecast at a 3-month horizon.

Further, the paper draws attention to the assumption of stability of correlation parameters over time. Again, a distinction should be made between Intra and Inter diversification where the later should show more stability and the former be more reactive to idiosyncratic and systemic factors.

- *§55: <...> supervisors may want to pay attention to ensuring that an adequate margin of conservatism is embedded in the estimates.*

Embedding conservatism is straight forward only for intra-risk modelling of one-sided risks. As soon as simultaneous gains and losses are possible, some measures to increase conservatism may turn out to be aggressive. The latter already applies to market risk, and - to a lesser but growing extent - to credit and operational risk. We disagree that conservatism should characterise Internal Models except in so far as such models may affect financial stability. We therefore reiterate the need to understand the stature of Internal Models in determining adequate levels of capital.

3.3 Sensitivity analysis

- *§61: The data to be shared with supervisors could include the following:*
  ~ Effects of the elimination (or addition) of significant parts of institutions' business (e.g. the sale of a business unit / merger according to strategic plans);
  ~ Changes in correlation assumptions; and
  ~ Impact of omitting from the model some of the risks / risk factors faced by the institution.

No distinction is made between scenarios relevant to the business and isolated modelling assumptions. The reference to "management actions" (§59) is irrelevant for the last part.

Chapter 4 - Internal model validation

This chapter appears to be a copy out of the respective parts of CEBS CP10. Insofar as this is the case, it incorrectly assumes implicitly that validation of Economic Capital models is similar to validation of IRBA parameters. Rather than just listing general requirements, whose scope is easily misinterpreted, it should provide some guidance to supervisors what they can and can not expect in a validation of models that attempt to estimate extreme tail risk.

- *§67: Supervisors consider it relevant that institutions aiming to claim diversification benefits within their ICAAP are able to demonstrate that they have adequate methods and processes for model validation in place.*

Using the term "claim" in this context suggests that supervisors would have the authority to withdraw diversifications benefits. This is not in the spirit of the ICAAP (same for §75). Put it another way – if the supervisor thinks that the firm is relying on the safety of diversification which the supervisor does not think is remotely valid, what should the supervisor do when it comes to the SREP? It should not amend the ICAAP, but it should perhaps reconsider the adequacy of the Pillar 1 charge to meet the risks of the firm. So perhaps it is actually the drafting of the CEBS paper that is at fault – to clarify that the SREP will come to a view, as part of the challenge process which we support – rather than to imply that the ICAAP will be "changed" or elements of it "disallowed".

- *§66: In order to avoid potential conflicts of interest and to ensure the highest level of integrity, it is important that the model validation is performed by an internal function of the institution which is sufficiently independent from the model design and development.*

This requirement would be burdensome and should best be regarded, in our view, as aspirational. This requirement, which we see as impractical, has already been discussed at length during the consultation of CP10.

Internal Capital Models are some of the more sophisticated models within a firm, often relying on Monte Carlo studies with embedded valuation techniques. The requirement that a firm employs two teams each capable of understanding how such models work is onerous.

Chapter 5 - Internal decision-making processes

5.1 Governance

- *§§76 & 77: <…> supervisors will pay due attention to how well the senior management understands the methodology used for internal capital calculations including reallocation of diversification benefits and, in particular, any possible shortcomings in this framework. <…> Supervisors are likely to be interested to know whether the uncertainties regarding model specification, data shortcomings or shortcomings in the validation of model results influence the board's final assessment of the institution's capital adequacy relative to its risk profile.*

This is an unrealistic implicit requirement that the board is to be informed of technical details like diversification parameter sensitivities. There is a similar requirement also in §82. We believe it is more realistic and pragmatic to expect a general briefing to be given to high level management to enable them to provide appropriate challenge. In this regard it would be useful to emphasise that the supervisor should discuss with firms individually what is considered appropriate management information.

Also, we note the phrase "reallocation of diversification benefits". We wish to make very clear that in many models correlation is modelled on exposure level data. There is no allocation of diversification benefit. To derive a "benefit" we would have to compare to a fictitious form of the firm in which correlation is elevated or even perfect.

5.2 Decision-making process and reporting

- *§80: It is therefore of interest to the supervisors to understand whether the diversification effects claimed are reflected in the same way that responsibilities on capital management, risk management, internal governance etc are distributed in the group.*
-

The statement is unclear.

- *§82: The nature and content of the communication to senior management and board members are key to ensuring that they correctly understand the underpinnings of the determination of diversification effects claimed by the institution.*

See §76. We agree with this request by supervisors, providing it is pitched at the right level of technicality. The board should understand the extent to which it can rely on diversification assumptions in general terms.

Chapter 6 - Comparing results of Pillar 2 and Pillar 1 capital calculations

We recognise the necessity to carry out a Pillar 1/Pillar 2 reconciliation in order to understand the differences between regulatory capital and economic capital.

Contrary to its introductory statement (§84), this chapter appears to be geared towards paving the way for a Pillar II capital add-on rather than enhancing the understanding of the industry's internal models by regulators.

6.1 Feasibility

- *§87: 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. Therefore, to address the overall contribution of diversification, reasons for differences between internal and regulatory capital numbers for Pillar 1 risks may have to be identified and highlighted.*

These are burdensome requirements (elaborated in §§88-94) without adding value for the institution but rather educating supervisors about the deficiencies of the Basel II prescribed models, which is not our job.

The reconciliation of Pillar 1 and Internal models is problematic. The Pillar 1 framework is a single factor framework, and any diversification benefit has to be effected through the parameters used (for example asset correlations).

Few firms use single factor models (and no real set of exposures is subject to a single factor). Consequently, the effect of diversification if appropriately and guaranteed to be greater than the Pillar 1 framework in this regard. Surely a firm should not be "penalised" for using a multi-factor model when, in fact, there are multiple factors?

More importantly, when a reconciliation is performed (one way or another), there is no unique way to allocate the effects of differing assumptions. Consider again the Pillar 1 credit risk framework: if we "control for" concentrations first, then the change in capital associated with, say, different asset correlations will certainly not be the same as that computed if we controlled for that difference first. Therefore, we do not see how it is possible to uniquely determine the effects of diversification.

Chapter 7 - Group dimension

- *§98f: <…> effective ability of the parent institution and/or the financial group as a whole to support any entity which for some reason faces difficulties meeting capital needs, <…>Additionally, a comfortable level of capital (i.e. well above CRD minimum requirements) and the availability/liquidity of the surplus will tend to demonstrate the effective capability of a group to support an entity where necessary.*

- *§100: <…> transfer of financial resources cannot always be made within a short period or under stressed circumstances. For example, local supervisory requirements, tax or other commercial/contractual/statutory provisions may create barriers or restrict the effective transferability of funds. These elements may therefore need to be carefully analysed when considering cross-border group diversification.*

These paragraphs address the distribution, availability and transferability of capital/financial resources within a group. We understand the importance of these issues and the necessity for the relevant supervisors to have information and confidence that capital is distributed appropriately within the wider financial group (and has the capacity to be transferred as the need arises). However, we think that this topic would be better positioned in a different, perhaps more general set of guidelines on Pillar 2, not in guidelines specifically designed to address diversification. Indeed it is essential to consider this dimension in delivering an overall Pillar 2 analysis of a group. We note that in fact the subject is already addressed in the CEBS Guidelines on the Supervisory Review Process

(e.g. RAS 2). Therefore, we suggest that it might be more appropriate to develop the group dimension points within this overarching guideline rather than with respect to diversification.

Annex – List of Possible Regulatory Questions

Question 15: In this question we suggest that correlation between realised number of defaults and realised losses per default event is taken into account and not the correlation between PDs and LGDs. Also, the meaning of "constantly" should be clarified.

October 2008