European Banking Federation

Secretary General

N°0623
WW/AH
Email

Mr Arnoud VOSSEN
CEBS
Secretary General
cp20@c-ebs.org

Brussels, 31 October 2008

Subject: ***EBF Position Paper on the" Consultation paper on technical aspects of diversification under Pillar 2"***

Dear Mr Vossen,

The EBF welcomes CEBS' intention to produce consistent guidance to EU supervisors on how they may engage into a dialogue with the banks on diversification benefits within the Pillar 2 framework.

We believe that it is essential for the EU supervisory community to acknowledge that diversification is a basic principle of due risk management and, moreover, that it should provide banks with appropriate incentives in this regard. Against this backdrop, the Consultation Paper is rather disappointing to the extent that it seems to suggest that supervisors will not approach diversification benefits "claims" in a benign way.

It would, moreover, be useful if the document would provide more context as to how the assessment of Economic Capital Modelling will interact with the measurement of diversification benefits. The understanding of many is that Pillar 2 was intended to establish a review process which aims primarily at assessing the quality of a bank's modelling processes and at examining issues such as internal governance validation, documentation and back-testing. Some supervisors, however, seem to prefer relying on a quantitative approach which primarily aims at challenging the accuracy of the ECM outcomes. At such a dialogue, possible capital add-ons to the Pillar 1 requirements are immediately at the forefront of the dialogue. The Consultation Paper seems to embrace both approaches at once, which we regret as this is not likely to foster convergence of supervisory practices across the EU.

These are some of the main comments made in the EBF position paper, which you will find attached.

Yours faithfully

Guido RAVOET

Encl.: 1 (D2108)

a.i.s.b.l.
10 rue Montoyer B- 1000 Brussels
+32 (0)2 508 37 11 phone
+32 (0)2 511 23 28 fax
http://www.ebf-fbe.eu

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CEBS CONSULTATION PAPER ON TECHNICAL ASPECTS OF DIVERSIFICATION UNDER PILLAR 2

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1. The EBF welcomes CEBS' intention to produce consistent guidance to EU supervisors on how they may engage into a dialogue with the banks on diversification benefits within the Pillar 2 framework.

   It also supports the work which CEBS' SON Group is currently undertaking in this area within the framework of its Operational Network Project as a **positive step**. Joint Pillar 2 assessments which are being conducted by colleges of supervisors will undoubtedly increase the supervisors' understanding of banks' economic capital modeling practices and contribute to increasing best practices.

2. It is essential for the EU supervisory community to acknowledge that diversification is a **basic principle of due risk management** and, moreover, that it should provide banks with appropriate incentives in this regard. Against this backdrop, the Consultation Paper (CP) is rather disappointing as it seems to suggest that supervisors will not approach diversification benefits "claims" in a benign way.

3. Our understanding of the CP is that it does not aim at proposing strict requirements which would need to be fulfilled as a pre-requisite for the assessment of diversification effects under Pillar 2 but rather at providing an **overview of areas of supervisory interest with respect to diversification.** The paper should make this clearer.

   As highlighted in the CP[1], ICAAP is a bank driven process which needs to be followed by a dialogue with supervisors. This logical order should not be reversed: the dialogue should not influence the way in which banks conceive their ICAAP.

4. The **scope of the CP** is extremely large as it touches upon issues related to the ICAAP in general such as internal governance, Pillar 1 and Pillar 2 reconciliation, models' development, group supervision issues, etc.

   Many of these have already been addressed in CEBS' "*Guidelines on the Application of the Supervisory Review Process under Pillar 2 (CP03 revised)*" and should therefore, not be dealt with again in the Diversification paper.

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[1] See Paragraph 9.

a.i.s.b.l.

10 rue Montoyer B- 1000 Brussels
+32 (0)2 508 37 11 phone
+32 (0)2 511 23 28 fax
http://www.ebf-fbe.eu

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Furthermore, we question if a Paper on Diversification should indeed go into issues which are not directly related to diversification within the framework of ECM (such as internal model validation, internal decision making and governance issues, stress-testing and sensitivity analysis).

Finally, and foremost, the paper should become more focused and, more particularly, better distinguish between areas of supervisory interest which are of high importance and those which should be of less interest.

This being said, diversification measurement and ECM are indeed closely interlinked. It would therefore be useful for the CP to provide more context as to how the assessment of ECM will interact with the measurement of diversification benefits. The understanding of many is that Pillar 2 was intended to establish a review process which aims primarily at assessing the **quality** of a bank's modelling processes and at examining issues such as internal governance validation, documentation and back-testing. Some supervisors, however, seem to prefer relying on a **quantitative approach** which primarily aims at challenging the accuracy of the ECM outcomes. At such a dialogue, possible capital add-ons to the Pillar 1 requirements are immediately at the forefront of the dialogue. The CP seems to embrace both approaches at once – which is not likely to foster convergence of supervisory practices across the EU.

Finally, the CP cannot ignore the **basic tension** which seems to be **inherent in the Pillar 2 Review Process**: whilst it is agreed that ICAAP is to be seen as a bank internal process, supervisors tend to strive for developing homogeneous assessment practices with a view to bringing consistency in their assessment, which is a valid concern. The CP should nevertheless acknowledge, however, that, as risk management is a key component of a bank's policy, different types of risk policies to manage different risk types are perfectly legitimate.

5. The CP and its Annex put much emphasis on the need for a prudent and conservative approach and seem, more particularly, to suggest that the **Internal Capital Modelling should be based on inherently conservative assumptions**. It needs to be reminded, however, that ICAAP is part of a bank's internal processes over which it has exclusive ownership.

   Economic capital models have not been developed for regulatory purposes but to help management in understanding the bank's effective capital needs and allocating resources within the bank. They have been set up to mirror internal structures and to reflect the risk management strategy developed by the bank's governing bodies. It is essential that they aim at achieving accuracy and, therefore, rely on best estimates reflecting realistic assumptions as regards to the risk profile. It would not add value to banks' risk management practices if they would be required to establish another (Pillar 2 Regulatory) capital model that would be used for supervisory purposes only.

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6. The CP is meant to discuss “the **technical aspects of diversification**”. However the CP deals more with Economic Capital Modelling (ECM) than with Diversification itself. The CP should include a conceptual framework explaining how regulators view diversification from the different perspectives:
   - geographic;
   - business mix (retail, wholesale, …)/Cross sector;
   - across legal/regulated entities;
   - across risk types (inter-risk);
   - within risk types (intra-risk).

7. The CP does not sufficiently differentiate between the needs and capabilities of smaller institutions and those of large usually internationally operating banks. For example, we believe that it would be possible and preferable to take account of the **needs of smaller banks** by not requiring them to make use of internal portfolio models for Pillar 2 purposes. The recognition of interdependencies between different types of risk is extremely complex, both in theory and in terms of implementation at a business level.

   In accordance with the principle of proportionality, we believe that smaller banks should be allowed to aggregate different risk types using summation.

8. It would be useful if the Section of the CP which addresses the **Group Dimension** would start reiterating that, where cross-border banks are concerned, home and host authorities must observe a cooperative framework when conducting the SREP, as emphasized in CEBS' “*Guidelines on the Application of the Supervisory review Process under Pillar 2*”. More particularly, the SREP can only be meaningful if it is conducted at the level of the group first and the situation of subsidiaries is examined at a second stage only, in a way which is consistent with the review undertaken at group level. Therefore, the leadership of the home supervisor in this process needs to be emphasised.

   This is particularly relevant when discussing diversification benefits as a review which would be conducted at a subsidiary level on a stand-alone basis would, *ipso facto*, ignore geographical diversification. It would furthermore overlook that the perception of a subsidiary's capital standing is strengthened by the mere fact that it belongs to a group. Finally, such an approach would be counter-productive as it would provide an incentive for groups to organise their subsidiaries on a monoline basis.

   It is in any event inappropriate for a “technical guidance paper on diversification” to overly focus on the question of transferability of financial resources.

9. When addressing diversification benefits, supervisors should be prepared to be more pragmatic instead of overly focusing on statistical approaches as, due to lack of data, some models/ correlations (e.g. operational risk correlations) need to rely on expert opinion.