ABI comments on

CEBS "*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"

June 2006

Introduction

On 23 March 2006 the Committee of European Banking Supervisors (CEBS) initiated a consultation on technical aspects of the management of interest rate risk arising from non-trading activities and concentration risk under the supervisory review process (Pillar 2). The paper sets specific guidelines: (i) for banks, for the management (detection, measurement, monitoring and control) of these risks and the effective allocation of internal capital; (ii) for supervisory authorities, for effective conduct of the review as part of Pillar 2.

To develop the Italian banking industry's position on the various proposals made in the consultation paper, ABI collected its members' viewpoints in structured, systematic fashion. On the basis of the observations received and the activity of several interbank working groups and of the European Banking Federation, BI has drafted the present paper. Approved by our Executive Committee, it has been transmitted to the supervisory authorities.

2. Comments of the Italian banking industry

The Italian banking system welcomes the CEBS consultation on technical aspects of the management of interest rate risk arising from non-trading activities and concentration risk. However, clarification is needed of any possible overlaps between this paper and the forthcoming consultation paper on stress testing. In fact, in dealing with IRBB and concentration risk, Consultation Paper 11 overemphasizes the stress test as an instrument; instead, it should envisage a higher-level approach, to avoid interfering with individual banks' specific risk management strategies.

In general, banks employ stress testing as an instrument to assess their capacity to cover losses out of the proceeds of ordinary operations, not to estimate possible losses due to market shocks. These instruments, moreover, should be based on

definite assumptions specified by the banks themselves. In other words, the use of scenarios based on parameters set by banking supervisors risk neglecting the special characteristics of each institution.

Below, we discuss the aspects of the consultation paper that warrant further specific study in the management of these risks.

2.1 Interest rate risk in the banking book (IRRBB)

Among the instruments for hedging interest rate risk arising from non-trading activities, IRBB-1 and IRBB-6 put excessive emphasis on internal capital. Actually, capital add-ons should be the last in a range of possible measures banks could take to cover these risks. This is the principle underlying the decision to treat interest rate risk in the banking book as part of Pillar 2 rather than Pillar 1, where capital requirements against the risks taken by banks in the conduct of their activities are set.

Though we agree in principle with the provisions of IRBB-4, we cannot help noting that the list of technical issues there is no more than a sort of prescriptive check-list. We suggest a more flexible approach based on the principles behind the guidelines: each bank should be free to devise what it considers the best strategy in view of its specific business.

As for IRBB-5, the 200 basis points suggested by CEBS to define supervisory currency shocks for purposes of controlling interest rate risk in banking book assets denominated in foreign currencies is severely penalizing, and not consistent with the best practices of the Italian banking industry. The evaluation of a standard shock depends on a large number of parameters that are subject to relatively sudden variations.

In this case too, it would be better to set less prescriptive guidelines, leaving it to the individual supervisory authorities to design specific stress tests as a function of the peculiar characteristics of the market in which the supervised banks operate.

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Guideline IRBB-9 provides that in the event of a reduction of more than 20 percent of own funds under the provisions of Article 124(5) of Directive 2000/12, the supervisory authorities can take additional measures beyond those listed in the guidelines, which already include: (i) improving risk management instruments; (ii) modifying internal limits on business in some assets; (iii) lowering the portfolio's risk profile; (iv) increasing regulatory capital.

Repeating that the level of 20 percent specified in the Directive is excessive, we hope in any case that supervisory authorities' actions are limited to the measures listed in IRBB-9, which are fully sufficient for the purposes of CP 11.

In addition, there is a need for greater detail on the procedures for calculating capital (VAR/sensitivity) and the area of application of the guidelines (a better definition of the assets classed in the banking book.

2.2 Concentration risk

In view of the release on 23 March of the questionnaire on large exposures[1], it would be good if the guidelines on concentration risk deriving from the current consultation were issued following specific study of the findings of that questionnaire.

As to the specific guidelines on concentration risk, concentration guideline no. 3 provides that banks must set "appropriate limits" for purposes of more efficient management of the credit risk arising from their activities. This provision creates considerable concern in the Italian banking industry, especially for banks whose mission already includes specific limitations on business, such as specialized banks (those doing only consumer credit business, say, or mortgage banks), or banks with local business(in Italy, mutual banks) but possibly with fairly diversified portfolios.

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[1] The large exposure questionnaire includes items on risk concentration, such as "What is your understanding of the nature of concentration risk?"; "For measurement of exposures, how do you define the amount at risk?"; "What is your approach to the management of single name concentration risk and other concentration risk (e.g. sectoral, geographic, etc.)?".

In order to obviate these problems, we suggest replacing the term "limit" with "indicators" or "areas of concern". Alternatively, these "limits" should be mutually discussed by banks and supervisors, and therefore without a specific check-list – as the consultation paper seems to suggest – which would be too rigid and not such as to take account of the special characteristics of individual banks (specialized or universal, local or international, etc.). Further, it should be made clear whether these limits are at nominal or at risk-weighted values.

As a second solution, should it be decided to retain the limits, we suggest that the concentration measurement techniques listed in §36 be extended to include an index that takes account of 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 by concentration guideline no. 5.

Concentration guideline no. 8 provides that in order to analyze concentration risk in banks' portfolios the supervisory authorities design internal models based on parameters or indicators derived from banks' reporting, including reporting on large exposures or geographic and sectoral risk.

There is a danger that the requirements and principles governing the fundamental criteria of the supervisors' models, calibrated for some types of bank (e.g., universal banks) could be used to monitor concentration risk for other types of bank (specialized, only local, and so on). Here too, therefore, we call for a more flexible approach by supervisors, taking account of the specificities of the individual banks and not interfering with their internal models and strategies.

As a second alternative, we ask that it be specified that where it is decided to use the quantitative indicators cited in the guidelines, the supervisory authority be required to inform the banks in detail of the methodologies used for evaluation and the threshold values (absolute and relative) above which concentration risk will be judged as high. Since the assessment of concentration risk is part of the broader supervisory review process, we think it would be helpful, if evaluation parameters different from the current ones are considered, for these to be notified immediately to the banks involved, to get their consent and, if necessary, prompt adaptation.

Further on concentration guideline no. 8, the Italian banking industry does not agree with the idea that supervisors may evaluate concentration risk using "qualitative" requirements such as management's expertise in identifying sectors at risk. First of all, it isn't clear what criteria the authorities could use to assess the expertise of the staff assigned to this task. Moreover, it is much more important that concentration risks be detected in quantitative terms and the most suitable measures for their mitigation be taken than that the management's degree of expertise be assessed; ratings of such standing would appear to be highly discretionary and subjective.

Finally, in addition to the mitigation methods listed in §37, we propose 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 already has a concentration of risk, 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.