23 March 2006

Questionnaire on the survey of market practices

Background

1. In December 2005, CEBS received from the European Commission a call for advice that will form part of the Commission's review of Large Exposures (LE). This review occurs in the context of Article 119 of the Capital Requirements Directive which requires that the Commission shall submit to the European Parliament and to the Council a report on the functioning of the Large Exposures rules, together with any appropriate proposals by 31 December 2007.

2. The second part of the Commission's call for advice asks CEBS to undertake an 'industry consultation' on current industry practices and thinking in relation to the measurement and management of concentration risk.

3. In the call for advice, the Commission states that this consultation should cover the full range of thinking on LE being undertaken at industry level, at all levels of consolidation. In particular, consideration of industry best practice and firms' own monitoring and reporting for internal purposes should be addressed. In this regard, the consultation should cover the full range of banking and trading activities. Regard should also be given to the needs of both smaller and larger firms, recognising that the needs of both may not necessarily be the same.'

4. Particular outputs of the industry consultation would include:
    a. An analysis of the measure(s) of exposures used by institutions for monitoring concentration risk as well as the horizon over which the risk is assessed
    b. An analysis of the manner in which institutions address Large exposures (e.g. specific capital reserves, use of credit risk mitigants etc)

5. CEBS understands that the industry consultation the Commission is referring to in the call for advice is in fact a survey of current market practices with regard to the measurement and management of single-name and other concentration risk. While the central focus of the LE review is single-name concentration risk, it is considered desirable to gain a full understanding of the inter-relations between the two areas

6. CEBS is in parallel consulting market participants on its high level guidance to both supervisors and institutions with regard to the management of concentration risk in the context of Pillar 2.

7. CEBS is aware that the industry is now faced with two related pieces of work from CEBS on concentration risk. CEBS would nevertheless prefer to run the two in parallel both to meet its timetable to respond to the Commission while implementing its Pillar 2 guidance.

8. With regard to the questionnaire below, CEBS understands that issues of confidentiality may arise from responses from individual institutions. The responses will be made publicly available unless otherwise requested by the respondents.

9. CEBS requests that the risk management function is involved in completing the questionnaire as CEBS wishes to understand how industry view and manage the risks.

10. The questionnaire is posted on the CEBS website for a three-month consultation. Responses should be sent to le@c-ebs.org by **16 June 2006**.

Guidance for completion

11. The questionnaire is designed to point respondents' towards a range of areas where CEBS is particularly interested in industry practices. It is not designed to elicit 'yes'/'no' type answers but rather seeks to provide the opportunity for respondents to provide full and detailed descriptions and explanations of their practices in relation to these different aspects.

12. In answering these questions, respondents are invited to provide as comprehensive and thorough answers as possible. It will be particularly helpful if respondents can fully combine in their answers their conceptual analysis together with comprehensive description of how such analysis is given effect in practical terms.

13. The main focus of the questionnaire is on the measurement and management of concentration risk for internal purposes. Questions are also asked about industry's experience of the current regulatory framework. CEBS also welcomes any other comments market participants may have on this issue.

14. It is likely that some institutions will have rather sophisticated approaches to the measurement and management of these risks, and that some will have a simpler approach, e.g. one related closely to the regulatory framework. CEBS is equally interested in learning about both.

15. Moreover, CEBS is equally interested in getting feedback from larger and smaller institutions. The aim is to gain a full and deep understanding of industry analysis, policies, practices and procedures.

16. The respondent is invited to answer the questions and comment from the perspective of an individual institution, but where there are differences at a group level these should be also highlighted.

Questionnaire

Please comment in respect of your approach to both trading and non-trading book issues and also where relevant on on- and off-balance sheet items.

General approach to concentration risk

1. In general terms do you, for internal purposes, adopt an approach to concentration risk measurement and management which is closely linked to the limits and reporting requirements contained in the current national regulatory regime. If so, please describe your approach. Note if your answer to this question is positive, many of the questions set out below may not be relevant to your circumstances.

Nature of concentration risk

2. What is your understanding of the nature of concentration risk?

   In answering this question you might address:

   - *how you define the risk of loss resulting from concentration of risk in the credit portfolio.*
   - *What is it you are managing when you consider significant single name exposures and concentrations in your credit portfolio?*
   - *what, for internal risk measurement and management purposes do you consider to be the risks associated with:*
     (a) single name concentration risk;
     (b) other concentration risk (for example – sectoral or geographic)

     For example, do you consider such risks as being related to ensuring that portfolio credit risk capital calculations are not undermined by incorrect correlation or diversification assumptions? Do you consider such risks to be related to 'tail event' losses – i.e. to protect against losses in the distribution beyond a chosen confidence interval? Do you consider them to be related to aspects of model risk or the real world simply not fitting the modelled world? Do you consider them to be related to time horizon aspects – e.g. large unexpected losses occurring over a short timescale rather than over the normally considered horizon e.g. 1 year? Etc.)

   We would be grateful if respondents could in their responses distinguish as clearly as possible between single-name and other concentration risks aspects.

Counterparties and relationships between counterparties for single-name concentration risk:

3. For your internal risk measurement and/or management purposes, how do you define 'connectedness' of counterparties? What factors do you consider determine 'connectedness'? To what extent and how, for your internal risk measurement and/or management purposes, do you take account of relationships / connections between counterparties (e.g. parent and subsidiary)?

4. For your internal risk measurement and/or management purposes how do you approach the issue of exposures to entities or products consisting of underlying assets or items (e.g. exposures to special purpose entities, collective investment units)? In what circumstances if any do you adopt a 'look through' approach? How do you calculate your risks in this context?

Measurement of exposures:

5. For internal measurement purposes, how do you define the amount at risk? In particular please outline your approach to loans, undrawn facilities, guarantees and similar obligations, derivative exposures (with future volatility), structured transactions, intra day and settlement exposures.

   For products where future exposure may fluctuate please outline your approach to this aspect (e.g. use a confidence interval, worst case scenario, other – please specify). If there are any other factors that influence the measurement of risk, please specify.

6. For your internal risk measurement and/or management purposes, How do measure:
   (a) single name concentration risk?;
   (b) other concentration risk? – sectoral, geographic, etc.

   In answering this question we would be grateful if you would provide a detailed explanation of the conceptual basis of your approach in this regard – VaR, expected shortfall, etc? Please provide actual and concrete examples.

7. Are these approaches closely integrated into your internal business decision-making? – please give examples. For how long have you adopted this approach?

   We would be grateful if respondents could in their responses distinguish as clearly as possible between single-name and other concentration risk aspects.

8. In relation to securities financing transactions (repurchase agreements, securities/commodities lending/borrowing agreements, margin lending), what approach do you take to the measurement of single-name exposures? Do you make use of an 'expected positive exposure'

methodology? Please describe in detail the approach adopted and the conceptual basis.

Monitoring and management of risk:

9. What is your approach to the management of single name concentration risk and other concentration risk (e.g. sectoral, geographic, etc.) Please provide a comprehensive and detailed descriptions and explanations.

   We would be grateful if you would provide a detailed explanation of the approach(es) you use to manage single name concentration risk? You might address:

   - *A full explanation of the conceptual basis for the approach that you operate.*
   - *Whether, and to what extent, the type of counterparty is a material factor in determining your approach to managing and mitigating the risk? For example corporates, credit institutions and investment firms, other financial, government, SPEs/structured transactions.*
   - *To what extent, if any, is the creditworthiness of the counterparty an important factor in the management of concentration risk. How is this aspect taken into account?*
   - *Whether you use an approach based on limits? If so, what are those limits? Do you set absolute limits (e.g. €50m) or limits relative to something else (e.g. 10% of capital)? If you use relative limits, what do you measure against? What factors do you take account of in setting limits (e.g. product type, banking book/trading book, tenor, rating, type of counterparty, credit-worthiness of the counterparty)? Do you set limits by counterparty or product? To what extent, if any, are portfolio effects recognised?*
   - *Whether you adopt an approach based on capital allocation in your management of risk. If so, please provide a detailed description/explanation?*
   - *Other than limits and/ or capital allocation, do you use any other risk management methodologies to manage single name exposure? If so, please tell us what you do and why.*

   We would be grateful if you would provide a detailed explanation of the approach(es) you use to manage other concentration risk (sectoral, geographic, etc). You might address:

   - *A full explanation of the conceptual basis for the approach that you operate.*
   - *Indication of other types of concentrations of credit risk you consider in your risk management (e.g., sector, country, collateral issuer – concerning the latter see question 13 below).*

- *How do you manage those concentrations (e.g. limits, capital allocation, or more informal monitoring etc).*

- *If you use limits, what factors you take into consideration in how they are set (e.g. credit rating of the government in setting country limits)?*

- *How you determine geographic, sectoral and/or other 'clustering' limits?*

- *Whether you use any risk mitigants against the concentrations identified above? If so, what are they? How do you take account of them?*

Stress testing

10. Do you adopt an approach to managing concentration risk based on stress-testing? If so please provide a detailed description/explanation.

    In your response you might include the events / situations for which you test; the conceptual basis for your approach in this regard; how often you carry out stress tests; and on what proportion of your exposures.

    We would be grateful if respondents could in their responses distinguish as clearly as possible between single-name and other concentration risk aspects.

Single entity vs. Group level

11. Do you set limits and/or apply your concentration risk measurement and management policies at a group level, sub-group level, and/or at individual entity level? Please provide details and explanation.

12. In relation to intra-group exposures please describe in detail the approach that you adopt. How do you set limits, allocate economic capital, etc in respect of such exposures? How do you approach the question of cross-border intra-group exposures?

Please provide as detailed as possible an explanation of the conceptual basis for your approaches in the above regards.

Credit risk mitigation

13. Do you use credit risk mitigation techniques as part of your approach to reduce single-name concentration risk? If so, please describe the methods that you use (e.g. collateral, guarantees, netting etc) and the circumstances in which you would adopt a particular approach and why you use that approach.

    In relation to funded credit protection you might address:

- *What types of collateral you use to reduce large exposure calculations for your internal purposes. Does this include collateral not recognised for regulatory capital purposes – please describe and explain your reasons.*

- *How you calculate the value, exposure-, or loss-reduction to be attributed to funded protection applied to large exposures? How you haircut the value of the collateral? How you take account of the frequency of re-margining?*

- *How do you take account of correlation between collateral asset values and events (systemic, idiosyncratic) giving rise to or arising from the default of the counterparty (e.g. the need to realise a large amount of collateral in a short space of time).*

- *Whether you use a 'top-slicing' approach – i.e. using credit protection to reduce the uncovered part of the exposure to a particular level e.g. the internal limit?*

- *Where you use netting agreements, the basis on which you calculate the net exposure? Please explain any differences between the regulatory and risk management netting sets (e.g. on-balance-sheet, off-balance-sheet, banking book/trading book etc).*

In relation to unfunded credit protection you might address:

- *What forms of unfunded protection you recognise as reducing credit risk (e.g. guarantees, credit derivatives). In what circumstances do you use these approaches?*

- *How do you take account of unfunded protection (e.g. substitution, adjustment of loss estimates, etc)*

- *How do you take account of correlation between the credit quality of the protection provider and events (systemic, idiosyncratic) giving rise to or arising from the default of the counterparty (e.g. the need to realise a large amount of collateral in a short space of time*

- *What policies do you have on who you will recognise as a credit protection provider (e.g. guarantor)?*

In relation to both forms of credit protection do you take account of any legal risk associated with credit risk mitigants? If so, how?

'Indirect Concentration Risk'

14. For your internal risk measurement and management purposes how do you deal with the issue of 'indirect concentration risk' – that is single-name or other concentration risk arising in respect of indirect exposures to the issuers of collateral or the providers of unfunded credit protection?

Governance and reporting

15. Please describe your internal governance and reporting policies and procedures relating to single-name and other concentration risk.

    In relation to this aspect you might address:

- *Your governance structure for setting, amending, and dealing with breaches of limits? Are limits hard or soft?*
- *What factors influence monitoring frequency?*
- *What information and reports are provided to senior management and how often? Why did you select that information as having significance? What elements of risk is senior management monitoring?*
- *Any other aspects of your concentration risk governance structure not covered above.*

Regulatory Environment

16. Please set out your experience of, and views concerning, the current large exposures regulatory regime.

    In your response, you might address:

- *Whether you consider the large exposures regime effective in addressing the key risks inherent in large exposures/concentration risk? Please give reasons for your view. How do you view the trade-off between the costs of the current framework and its benefits in terms of, for example, prudential soundness, simplicity, cross-border harmonisation, competitive fairness, etc.*
- *Whether you feel that the current limits are satisfactory, both from a prudential and from a level playing field perspective?*
- *Whether you feel that the current limits are adequate for all institutions and that the level of the limits should be commensurate with the risk profile of the institution*
- *Whether you feel that the large exposures regulatory regime should capture (and limit) concentration risks (sectoral, geographic). Please explain the rationale.*
- *The extent, if any, to which the current regulatory regime constrains actions that you would otherwise have taken? Have the large exposures provisions impacted your business decisions? If so, in what way (e.g. competitiveness, cost, management time, opportunity cost/gain)? If an international institution, please also explain in global context.*
- *The consistency of current regulatory limits with internal management practices? To what extent do you use the information that you supply to meet the regulatory requirements for large exposures, and the systems that you use to capture and process that information, in your own risk management?*

17. What is your perception of how the large exposures regime is applied across different member states? Is it applied in a consistent way? If not, what differences have you encountered and how have they impacted on your business.