CEBS draft revised Guidelines on aspects of the management of concentration risk under the supervisory review process (CP31)

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CEBS

Committee *of* European Banking Supervisors

Outline

- Role and tasks of CEBS
- Current framework of CEBS guidelines on Pillar 2
- Background to revision of the existing guidelines
- General considerations and principles for concentration risk management
- Specific concentrations in individual risk areas
    - Credit risk
    - Market risk
    - Operational risk
    - Liquidity risk
- Supervisory review and assessment
- Implementation and follow-up work

The role of CEBS – main objectives and tasks

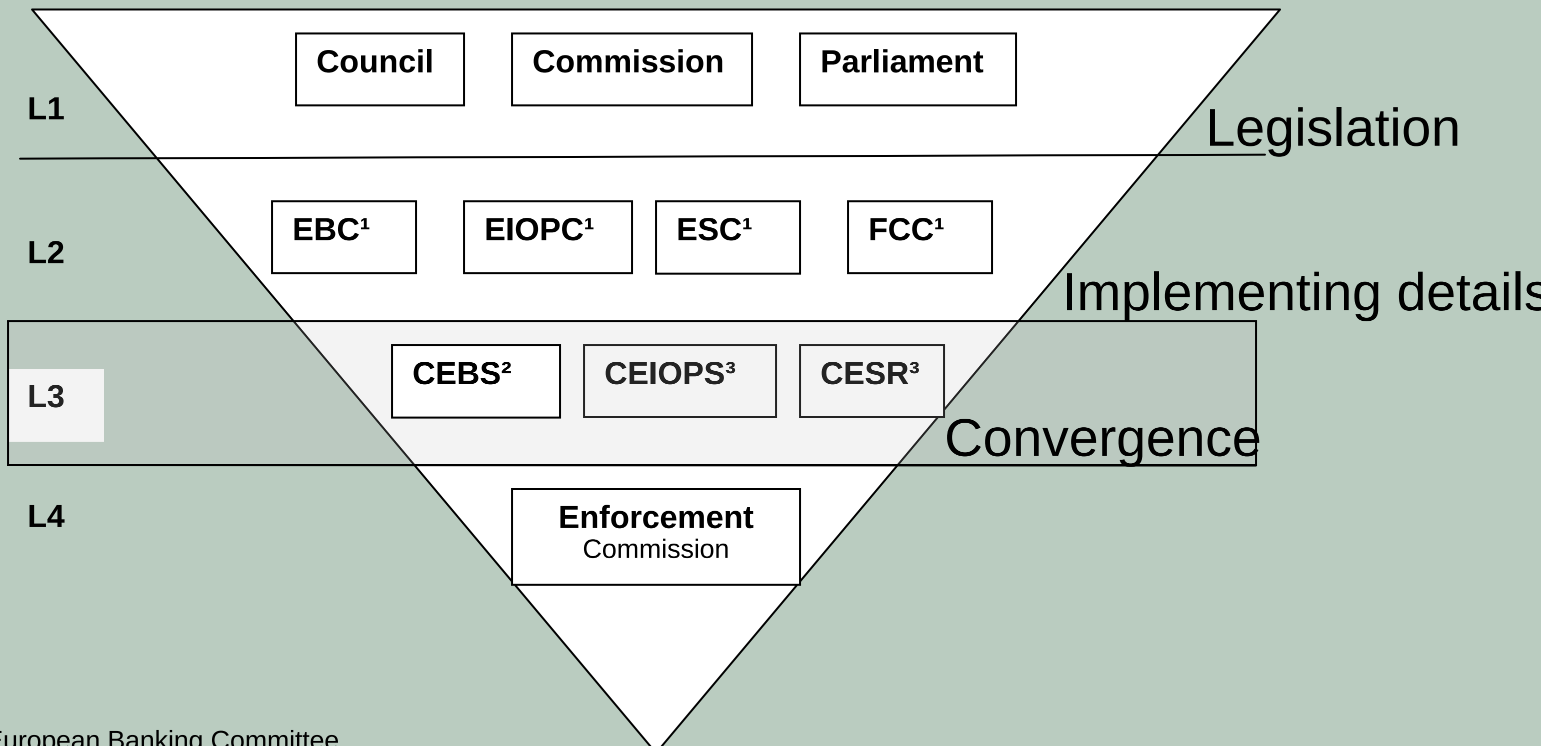
Objectives:

- Promote efficient and effective supervision, and the safety and soundness of the EU financial system, through:
  - Good supervisory practices
  - Efficient and cost-effective approaches to supervision of cross-border groups
  - Ensuring a level playing field and proportionality

Main tasks:

- Give advice to the Commission
- Promote consistent implementation/application of the EU banking legislation
- Promote convergence of supervisory practices
- Promote information exchange and supervisory cooperation
- Encourage efficient and consistent functioning of colleges of supervisors

The role of CEBS - the Lamfalussy structure



EBC = European Banking Committee
EIOPC = European Insurance and Occupational Pensions Committee
ESC = European Securities Committee
FCC = Financial Conglomerates Committee
CEIOPS = Committee of European Insurance and Occupational Pensions Supervisors
CESR = Committee of European Securities Regulators

[1] Finance ministries
[2] Supervisors and Central Banks
[3] Supervisors

The current framework of CEBS Pillar 2 Guidelines

Guidelines on the Supervisory Review Process under Pillar 2 (GL03), 2006

Annex on IRRBB, 2006

Annex on concentration risk, 2006

Annex on stress testing, 2006 → CP32, 2009

Section on Internal Governance

Section on ICAAP

Section on SREP

Section on RAS

Section on ICAAP-SREP Dialogue

High-level principles for remuneration policies, 2009

High-level principles for risk management, 2010

ICAAP-SREP Dialogue on diversification (CP20), 2008 – not finalised

Set of home-host guidelines and college related documents (template for written agreements, Good Practices paper)

Context – importance of concentration risk

- Concentration risk defined as any significant inter-related asset or liability exposures, the combined performance of which may adversely affect the soundness of an institution
- Concentration risk is not fully captured by the Pillar 1 (Basel II/CRD) framework, and therefore needs to be assessed under Pillar 2
- Under stress scenario (e.g. distress in some markets/ sectors/ countries or areas of activity) concentration risk may result in losses or negative impacts in more than one risk category
- Concentration risk may arise from economic connections which are not readily apparent and easily identifiable
- Lessons learnt from the recent financial crisis:
  - Concentration risk was not sufficiently understood/addressed
  - Concentrations of risk emerged that had not been anticipated

Context – drivers for the revision of the guidelines

- Need to incorporate key lessons learnt from the crisis
- Previous version of the guidelines too focussed on credit concentration risk
- Rolling programme to update and revise CEBS Pillar 2 guidelines to reflect actual experience with the implementation of Pillar 2 in Europe, and to increase convergence
- Alignment with revision of the large exposures rules (one particular aspect of concentration risk) and publication of new CEBS guidelines for LE
- Incorporate key elements of Joint Forum paper on risk concentrations (April 2008)
- Importance of concentration risk highlighted by the CEBS micro-prudential assessment of risks and vulnerabilities in the EU banking sector

Revised guidelines – what's new?

- Broader approach to concentration risk measurement and management, not just credit concentration risk
- Mirror of diversification analysis, highlighting
  - concentration risk only within a risk type (intra-risk analysis),
  - concentration risk across risk types (inter-risk analysis)
- Holistic approach to enterprise-wide concentration risk management
- Specific aspects of concentrations within credit, market, operational and liquidity risks, but by not simplistic "silo" approach – emphasis on the global view
- Extended guidance for supervisors and supplementary implementation pack (not part of the public guidelines)

Governance aspects and management framework

- Concentration risk management – integral part of the oversight and risk management framework
- Roles of governing body and senior management
- Integrated approach to intra- and inter-risk concentration, including second round effects and feedback loops
- Appropriate identification of existing concentrations across and within risk types
- Forward looking approach to identification by means of monitoring of economic environment and use of stress testing

Measurement and monitoring framework

- An institution should be able to evaluate and quantify the impact of risk concentrations on its earnings/profitability, solvency, liquidity position
- The measurement framework should capture interdependencies between risk exposures
- Institutions should actively manage risk exposures by using top-down and group-wide concentration risk limits and internal target ratios (including appropriate sub-limits across business units and across risk types)
- Ongoing analysis of portfolios and exposures should be supported by the appropriate reporting framework

Integral part of the ICAAP and capital planning

- Concentration risk to be adequately captured within the ICAAP and capital planning frameworks
- Capital should be allocated to concentration risk
- The higher the levels of concentration, the greater the onus on institutions to demonstrate how they have assessed the implications in terms of capital

Credit risk concentration

- Extension of concentration risk measurement beyond connected customers (e.g. single name concentrations for Large Exposures) to economic sectors, products, geographies
- Focus on exposures across the banking and trading books (counterparty risk and exposures, particular instrument types exposed to the same idiosyncratic risk)
- Attention to modelling techniques and assumptions - e.g. not all exposure classes will behave in the same way across all the geographies where institution operates

Market risk concentration

- Particular focus on the way concentration risk is captured in VaR models and model based limits – risk of overestimating diversification effects
- For market liquidity risk – focus on effects of changing liquidity horizons, which need to be considered in setting limits

Operational risk concentration

- New and little explored concept
- Single operational risk exposure or group of operational risk exposures could have potential to produce losses large enough to affect the institution's overall risk profile
- Business model or organisational structure risks
  - e.g. institutions with large payments and settlements functions or that are active in high frequency trading or that are dependent on one or few external suppliers/providers
- Possible risk concentrations to be taken into account in the evaluation of operational risk exposure, e.g. by means of analysis of patterns of frequency and severity of op risk losses

Liquidity risk concentration

- Understanding and monitoring of funding structures – balance between sources, currencies and markets
- Understanding of market liquidity risk and funding liquidity risk as well as the possible interaction of the two
- Mixture of qualitative assessment and quantitative ratios (link to the proposed overhaul of liquidity regime)
- Liquidity risk concentration to be taken into account in setting up contingency funding plans

Supervisory review and assessment

- Concentration risk reviewed as part of the Pillar 2 SREP – both a qualitative and a quantitative review process
- Assessment of adequate allocation of capital and liquidity buffers a key element of SREP
- Mitigation should not create a new concentrations
- Where risk not mitigated, full spectrum of supervisory measures under Art 136 (1) and (2) of the CRD available
- Supervisors expected to pay particular attention to highly concentrated (e.g. specialised) institutions

Implementation

- CEBS will expect its members to apply the new guidelines, once finalised, from **31 December 2010**
- Proportionate implementation (from simple to more complex approaches) and flexibility for national supervisors regarding the implementation of specific aspects
- Implementation by institutions will be monitored by national authorities
- CEBS/P2CN is developing materials to assist supervisors in implementation of the guidelines (examples of supervisory questions and practices)
- CEBS will conduct an implementation study approximately one year after the implementation date

Immediate follow-up work

- Public consultation runs until **31 March 2010**
- Please send your written comments to the following e-mail address: cp31@c-ebs.org
- Comments received will be published on CEBS website unless respondents explicitly request otherwise
- Final version of the new guidelines will be available in Q3 2010

Questions and answers

- Do attendees agree with the broad principles covered in the guidelines?
- What issues could be flagged to CEBS to keep in mind in the finalisation of the guidelines?
- What further work can the CEBS do to help institutions to implement the guidelines?

Thank you!

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