INTESA SANPAOLO

**Intesa Sanpaolo Group Position Paper
on EBA document:
"Draft Regulatory Technical Standards
on the specification of the assessment methodology
for competent authorities regarding
compliance of an institution
with the requirements to use the IRB Approach
in accordance with Articles 144(2), 173(3) and 180(3)(b)
of Regulation (EU) No 575/2013"**

March 2015

- **General comment**

Generally speaking, the RTS clarify the competent authorities' expectations on several issues concerning internal rating systems methodologies and processes. As pointed out in a recent IIF study, which Intesa Sanpaolo contributed to, banks generally advocate for more guidance from regulators, in order to reduce areas of discretion and enhance transparency and comparability. The RTS are thus welcomed as far as they help achieving those goals.

However, we are concerned about some specific requirement apparently limiting the CRD and CRR interpretation beyond the original purpose of the rule: this is in particular the case of long run default rates, on which we comment below.

Moreover, we note that, on several topics covered by the RTS, the EBA is expected to bring out additional standards or guidance in the coming months (e.g. definition of default, downturn, etc). We recommend that the new regulations should be developed according to a plan ensuring consistency across the various releases envisaged.

- **Long run default rate**

Q3: Are the provisions introduced in Article 49(3) on the calculation of the long-run average of one-year default rates sufficiently clear? Are there aspects which need to be elaborated further?

C3: As far as we can understand, the proposal introduces an asymmetric approach as in a recessionary phase of the economic cycle the recent observed internal data of default, higher than the long average, are a floor, while in an expansionary phase external data must be used to adjust upwards the internal observations. Note that presumably the length of internal time series will always be limited because of structural changes in organizations, in definition of default, and so on. Hence it is very likely that this asymmetric approach will apply in a large number of circumstances.

In the chart below, we plot as an example the time series of default rates in Italy (doubtful loans of non-financial companies, source Bank of Italy). The asymmetric treatment of countries/regions/segments which are on different phases of the cycle is evident.
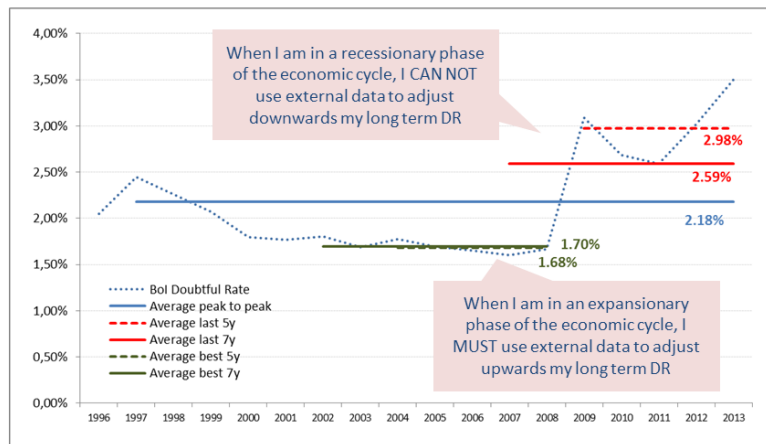
The outcome of the requirement is a mixed approach between PIT and TTC logic, undesirable from a methodological point of view and with negative implications in terms of pro-cyclical effects (reduction of volume of credit, tight conditions, revisions of delegated power etc.). Note also that it fails to achieve the declared objective that "extensive cyclicality of own funds requirements is avoided", because after a recessionary phase (as it may be the case for most European countries in the next years) banks would be allowed to repeatedly revise downwards their PD calibration until the internally observed average default rate has reached the long term average.

More generally, we remark that both the regulatory standards and the industry practices still lack a clear definition of what is PIT/TTC, as well documented by the IIF study mentioned above. This affects also the reliability of PD backtesting, because for example the standard binomial test on last year(s) PD and default rates is suited only for pure PIT rating systems, while for TTC or hybrid systems the comparison between the two should take into account the level of the cycle in the backtesting period and the degree of cyclicality of the rating system.

We believe that a framework of PD calibration should be developed, encompassing a measure of rating system stability and a consistent set of PD backtesting.

- **LGD default weighted**

Q4: Do you agree with the required number of default weighted average LGD calculation method introduced in Article 51(1)(b) and supportive arguments? How will this requirement influence your current LGD calculation method? More generally, what are your views as to balance of arguments for identifying the most appropriate method?

C4: We agree with the default weighted average LGD calculation method proposed in the document.

In our opinion this approach is preferable because, on one hand, it allows to use the exposure at default as risk driver when it is statistically significant and predictive and, on the other hand, potential bias effects caused by too small/big defaults in the exposure weighted approach can be avoided; thereby the management of counterparties' size is more effective.

However, we ask to maintain a certain degree of flexibility: in particular for low default or small portfolios, where it may be impossible to break down the sample in pools with a statistically significant number of observations, the exposure weighted average LGD calculation method can be a second best technique to factor exposure size into the model.

Finally, we agree with the exposure weighted method for the floor definition since the latter represents the whole portfolio and not the single exposure.

- **Additional comment on art. 51**

The statement "the capitalized unpaid late fees are added to the institution's measure of exposure and loss" should be elaborated further. It is not clear: a) whether those items should be always added to EaD or only when they are capitalized according to accounting practice; b) whether cash in from them should be added to recovery cash flows always or only when capitalized. Please note also that this topic could be influenced by different accounting practices among banks.

- **Multiple defaults**

Q5: Are the provisions introduced in Article 52 on the treatment of multiple defaults sufficiently clear? Are there aspects which need to be elaborated further?

C5: We think that the provisions should be further elaborated with more detail, for example with reference to the "short period of time" mentioned in the document, possibly allowing for differences among risk components and/or steps of the development process.

- **Art. 53/54 Text for consultation purposes**

Art. 53 and 54 deal with the concepts of "economic downturn", which concerns the performing exposures, and the "unexpected loss that might occur during the recovery period", which concerns the non performing exposures.
As stated in the Background and Rationale, "LGD for defaulted exposures should reflect the sum of expected loss under current economic circumstances and possible unexpected loss that might occur during the recovery period whereas the LGD for non-defaulted exposures always reflects the downturn conditions".
Our understanding is that the two concepts are different, though obviously connected. We believe that additional guidance is needed to clarify the difference between them.

- **Eligible guarantors**

Q6: Are the provisions introduced in Article 60 on the treatment of eligible guarantors for the purpose of own-LGD estimates sufficiently clear? Are there aspects which need to be elaborated further?

C6: The provisions introduced on this issue are sufficiently clear.
It should be useful to confirm if retail entities (individuals, SME retail counterparties…) are included among "guarantors that are internally rated with a rating system approved under the IRB approach", with the consequent possibility of portfolio translation in case of eligible guarantees for the calculation of risk-weighted assets.

- **Cost benefit analysis**

Q7: Do you support the view that costs for institutions arising from the implementation of these draft RTS are expected to be negligible or small? If not, could you please indicate the main sources of costs?

C7: Generally speaking, development and implementation costs may arise as long as the existing models need to be redeveloped or adjusted in order to comply with the RTS. Moreover, strict compliance may be impossible whenever the new rules require the backward retrieving of data that are no longer available.
Hence, we suggest that EBA should consider transitional arrangements and/or grandfathering provisions in order to smooth the convergence towards compliance with the RTS.

Q8: What are the main benefits for institutions that you expect by the adoption of these draft RTS?

C8: This draft RTS give a clearer understanding and guidance of what is expected by competent authorities on several issues concerning internal rating systems methodologies and processes. This helps to reduce areas of discretion and enhance transparency and comparability, thus contributing to create a level playing field.

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