INTESA SANPAOLO

Intesa Sanpaolo responses to the EBA Consultation Paper

"Draft Guidelines issued on the basis of Article 84 (6) of Directive 2013/36/EU specifying aspects of the identification, evaluation, management and mitigation of the risks arising from potential changes in interest rates and of the assessment and monitoring of credit spread risk, of institutions' non-trading book activities"

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Executive summary

We would like to thank the European Banking Authority for the opportunity to comment on this consultative document and, in particular, to leave room for some discussion on credit spread risk in the banking book (CSRBB) that is a very complex and controversial argument. Moreover, we would like to briefly express our view on some key topics included in the Draft Guidelines:

- the five-year cap repricing maturity for retail and non-financial wholesale deposits should not bring to substantial consequences since it was formerly included in the supervisory outlier test, which is part of the internal measurement system. Nevertheless, in our view, the internal measurement system (IMS) should be subject to prudential assessment and management with a specific focus for the behavioural items not subject to regulatory quantitative constraints. Imposing a five-year cap to the average repricing maturity of non-maturity deposit (NMD), it could misrepresent institutions' interest rate risk profile and could be in contrast with the outcomes of the internal models and empirical evidence and hence constraint a business model that uses NMD as a natural hedge for long term fixed rate loan/mortgages. Besides that, the IMS should be subject, by definition, only to the prudent qualitative principles of measurement and management of the Guidelines. We underline that internal models are subject, not only to internal validation and audit processes, but also to the controls of the Competent Authorities. Taking into account these considerations, **we suggest removing paragraph 111**;

- the criteria to identify non-satisfactory IMS are, in general, sufficiently clear. Some minor amendments should be introduced as to better clarify the rationale since it's not clear where the criteria apply to internal models only (i.e. behavioural models) or to the internal measurement system (of which internal models are part);

- the identification of CSRBB and the impact of CSRBB on NII are not sufficiently clear. For this reason, we suggest including concrete examples. Moreover, it is not evident if CRRBB should be limited to assessment and monitoring or should be also subject to RAF limits as IRRBB;

- **the CSRBB perimeter should be in line with the current EBA Guidelines and BCBS Standards, including only items at fair value without further perimeter extensions**. The inclusion, in the perimeter of the banking book, of instruments that do not have a market price (loans, non-maturity deposits) would raise an issue on the related risk management (for example institutions should deal with mitigation actions on retail loans) and would increase considerably the costs of compliance;

- the separation of IRRBB and CSRBB in the Guidelines are generally straightforward. We suggest clarifying in the Definitions of Net Interest Income measures if "interest income, interest expenses and market value changes" refers also to credit spread changes.

As general remark, NII sensitivity measures should not include fair value changes (as envisaged in paragraph 15 of the Draft GL and in the Article 5b of the Draft RTS, where EBA is seeking a specific feedback about inclusion or not of this component in the SOT NII). Our proposal is to exclude this component from the NII SOT and NII internal measures, to be in line with the definition of net interest income and the interest rate risk management, to improve the coherence and to reduce the differences between IMS and SOT measures, avoiding double counting with EVE measures.

Questions

Question 1: In the context of the measurement of the impact of IRRBB under internal systems, paragraph 111 envisages a five-year cap repricing maturity for retail and non-financial wholesale deposits without a specified maturity. Would you foresee any unintended consequence or undesirable effect from this behavioral assumption in particular on certain business models or specific activities? If this is the case, please kindly provide concrete examples of it.

The paragraph 111 of the Consultation Paper (EBA/CP/2021/37) and the paragraph 115 (o), included in the current EBA Guidelines (EBA/GL/2018/02) and used for the calculation of the supervisory outlier test (SOT), contain the same provisions . For this reason, we do not expect any immediate unintended consequence on the supervisory outlier test (SOT).

On the other hand, moving the five-years cap from the SOT to the IMS, may conduct to a misrepresentation of the actual interest rate risk profile of the bank and may consequently impact the ALM strategy and profitability.

We agree with the EBA's view to support a prudential approach for the modelling of non-maturity deposits (NMD). Nevertheless, we find that the introduction of regulatory constraints, for the NMD maturity, would be a sort of measurement's standardization, in contrast with the concept of 'internal measurement system' that should be based on the application of methodologies chosen by the institutions. Furthermore, it could be in contrast with the outcomes of the internal models and the empirical evidence.
We would like to emphasize that internal models are subject not only to internal validation and audit processes but also to Competent Authorities' controls.

Moreover, paragraph 112 already provides guidelines on the prudent approach institutions should follow (i.e. "*Ensure that assumptions about the decay of core and other modelled balances are prudent and appropriate in balancing the benefits to net interest incomes against the additional economic value risk entailed in locking in a future interest rate return on the assets financed by these balances, and the potential forgone revenue under a rising interest rate environment*").

Paragraph 47 c) states that "*Capital adequacy assessments for IRRBB should take into account the following: […] the sensitivity of the internal measures of IRRBB to key or imperfect modelling assumptions*"
Consequently, in our opinion, there is no need to impose a cap to the NMD repricing for prudential reasons and so we suggest removing the paragraph 111.

Question 2: Do respondents find that the criteria to identify non-satisfactory IRRBB internal models provide the minimum elements for supervisors' assessment?

The criteria to identify non-satisfactory IMS are in general clear. However, some doubts arise from paragraph 119 b: "*IMS should be considered as non-satisfactory if they are not calibrated, back-tested and reviewed in all their relevant parameters on an appropriate frequency […]*". It is not intelligible if it refers exclusively to internal models or to the metrics used to measure the economic value and net interest income sensitivity. In our opinion, only the internal models should be subject to calibration and back testing procedures and not the outcomes of the methods listed in Annex I. We propose to replace the word "IMS" with "Internal models" and modify the paragraph as follows: "*Internal models should be considered as non-satisfactory if they are not calibrated, back-tested and reviewed in all their relevant parameters, using an appropriate frequency […]*". Otherwise, it should be better specified which components of the IMS, other than behavioural models, should be considered relevant to identify whether they are non-satisfactory.

Question 3: Is there any specific element in the definition of CSRBB that is not clear enough for the required assessment and monitoring of CSRBB by institutions?

The definitions are not clear. Credit spread is the additional spread over the risk-free rate, required by the market, for the compensation of borrower's default risk (a simplification for illustrative purposes). It is not clear if the market credit spread is intended as:

1. the difference between the yield derived from the bond issued by one specific borrower and the risk-free curve (typically Euribor curve); or
2. the difference between the yield derived from a yield curve built computing (for example averaging) the bond's market yield being issued by different borrowers all with the same currency and rating, and the risk free curve (typically Euribor curve).

Consequently, the term "market" used in the definition is not clear, since it is not possible to understand if it is referred to the yield of a specific bond, as in the first case (see Point 1 above) or to a generic yield curve built considering all market bonds with the same currency and rating (see Point 2 above).
Furthermore, the word "market" used in the Definitions may be misleading, suggesting that the CSRBB perimeter should include only instruments negotiated in active liquid markets. If this is not the case, we suggest clarifying the true aim of the term.

Some explanations, possibly with examples, on what are the EBA expectations would be more than appreciated.

As for the "market credit spread", it is not clear if the "market liquidity spread" (that represents the "liquidity premium that sparks market appetite for investments and presence of willing buyers and sellers") refers, like the credit risk premium, to a generic yield of a given rating or to the specific bond issued by a given borrower.

Moreover, regarding the following reference *"the deterioration of an institution's credit quality should not have any positive impact on the credit spread risk measure"*, contained in paragraph 121, it is not clear if the institution's quality deterioration should not have any positive impact in case of a rating downgrade (migration risk) or if, in general, institutions should not consider the positive effect that a deterioration of credit spread has on liabilities in terms of fair value.

Paragraph 123 *"When assessing changes in credit risk premium and liquidity premium movements, institutions can consider currency specific dimensions (i.e. EUR, USD, etc.) as a relevant dimension for market credit spread and market liquidity spread."* It is not clear if the currency is the only dimension to be considered in building the generic yield curve with a certain rating or if there are other "dimensions" that should be considered.

In the "Definitions", regarding Net Interest Income measures, the draft GL state that "*Measures of changes in expected future profitability within a given time horizon resulting from interest rate movements, in case of IRRBB; or from credit spread changes, in case of CSRBB. It encompasses interest income, interest expenses and market value changes.*" It is not clear if market value changes include also fair value changes deriving from credit spread changes (other factors being equal). In our opinion, market fair value changes, derived from interest rate or credit spread changes, should not be included in the Net Interest Income measures.

In general, the definition is not clear about how CSRBB should impact the NII, especially considering that a credit spread increase would have no impact on the coupons received from existing position. and would have a positive effect on NII, in case the position maturing in the time horizon, is replaced (under the constant balance sheet assumption) by similar securities yielding higher coupons due to the increase of the credit spread. Examples provided by EBA would be helpful to clarify this doubt.
Doubts also arise if CSRBB should be subject to RAF limits or not. We find a contradiction between the explanatory box in page 45 ("Furthermore, the Guidelines basically capture general governance related aspects, outlining the expectations in terms of a responsibilities, IT systems and internal reporting framework, **without setting any specific internal exposures limits**") and paragraph 146 ("The CSRBB reports should provide aggregate information as well as sufficient supporting detail to enable the management body or its delegates to assess the sensitivity of the institution to changes in market conditions and other important risk factors. The content of the reports should reflect changes in the risk profile of the institution and in the economic environment, and **compare current exposure with policy limits**").

Question 4: As to the suggested perimeter of items exposed to CSRBB, would you consider any specific conceptual or operational challenge to implement it?

In our opinion, CSRBB should consider only the risks actually faced by the institutions based on their business models and in a 'going concern' perspective. It should be considered that the banking book is mainly based on assets and liabilities that are not traded in any market and, according to the business model, are held until maturity. Consequently, they are exposed to credit risk but not to credit spread risk, which would potentially materialize only in exceptional cases[1].

As a consequence, in our view, extending the CSRBB to other instruments such as loans, mortgages and non-maturity deposit (NMD) would be extremely complex, would raise some methodological issues (for example the positive impact that an increase of the institution credit spread will have on the fair value, offsetting the negative impact deriving from an increase in the credit spread on the asset side, or, the measurement of the credit spread risk on the modelled NMD) and most of all would be burdensome and costly (requiring expensive administrative and IT investments).

Furthermore, since these items are accounted at amortized cost, according to the business model, an extension of the perimeter considering all of them would be a deviation from the BCBS Standards, which limits the CSRBB to items accounted at fair value (please refer to Figure 1 – Components of interest rates in Annex I paragraph 1.3 of the Standards). Not to mention the current Guidelines which in addition limit the scope to the asset side (thus excluding liabilities).

For these reasons, the perimeter should be limited to actively traded assets (i.e. assets negotiated in regulated liquid markets) with observable prices included in the banking book. Since some of these securities, depending on the business model, are accounted at fair value through other comprehensive income (Held To Collect and Sale or HTCS), changes of credit spreads would have a direct and immediate impact on capital (through revaluation/devaluation of reserves). This perimeter would be in line with the current EBA Guidelines, BCBS Standards and the current internal practices of the institutions.

A reasonable extension of the perimeter on the asset side could be to securities negotiated in active markets classified at amortised cost (Held To Collect or HTC). The HTC securities may have potentially an impact on capital in case of a sale or may be reclassified as HTCS. Another possible extension could be made including in the perimeter of CSRBB also the direct funding need for investments in HTCS and HTC (i.e. repos).

Question 5: **Is the separation of IRRBB and CSRBB sufficient to understand where the guidelines apply to:**

- **IRRBB only;**
- **CSRBB only;**
- **Both IRRBB and CSRBB.**

We find the separation is sufficiently clear. However, in the definitions regarding "Net Interest Income measures", it is stated that *"It encompasses interest income, interest expenses and market value changes."* making it unclear if interest income, interest expenses concern and, more importantly, market value changes refers also to credit spread risk. We suggest a clarification in this respect.

[1] For example, in a liquidating scenario when the institutions is "gone concern".