

## Intesa Sanpaolo responses to the EBA Consultation Paper

**“Draft Regulatory Technical Standards specifying supervisory shock scenarios, common modelling and parametric assumptions and what constitutes a large decline for the calculation of the economic value of equity and of the net interest income in accordance with Article 98(5a) of Directive 2013/36/EU”**

April 2022

### Executive summary

We would like to thank the European Banking Authority for the opportunity to comment on this consultative document.

As to improve the clarity and the coherence with internal risk management practices, we suggest introducing few amendments in the RTS as reported below. The main key points are:

- the common modelling and parametric assumptions for the EVE SOT and the NII SOT in Articles 4 and 5 are clear enough and operationally manageable. Some minor changes could be made to improve clarity about the weight to apply to euro positive changes; the new -1,5% floor for immediate maturity is too low for all currencies (with the only exception of CHF rates). In our opinion, **the current EBA floor should not be changed** but instead we suggest **changing the current rule to be applied when rates are below the floor (we propose an alternative easier to implement)**. Regarding the NII SOT, we agree on the one-year time horizon and the constant balance sheet assumption, but it should be **clarified that the new commercial margins have to be kept constant when calculating the NII sensitivity** in order to reflect only the change of risk – free interest rate. We are also **in favor of the exclusion of the fair value from SOT NII** (and, for coherence, also from the IMS). Moreover, some doubts arise about what element should be considered in assessing the impact on NII. In consideration of the above, **we propose to remove the paragraph b of Article 5**;
- the **thresholds proposed by EBA for the NII SOT are too stringent** (for the metric 1 it is 2,5% or 3% if fair value is included and 35% or 30% if fair value is included for metric 2). The threshold for the large decline should be set in order to be compatible with EVE SOT, to avoid that an institution may be compliant with the EVE SOT but not with the NII SOT and should be independent from the lower bounds. For this reason we suggest, as a minimum, to calibrate the threshold under the QIS “scenario 2 unconstrained” (parallel down without any floor). Regarding the choice of the metric for the NII SOT, we suggest adopting the **metric 1, for the NII SOT, because it is simpler and less volatile**;
- the management of the two thresholds (NII SOT and EVE SOT) will be influenced by the introduction of the new accounting framework for macro fair value hedge (currently under construction) which will introduce further constraints on the management of IRRBB. So, we ask for a timeframe coherence between the RTS and new accounting framework date of application.

Questions

Question 1

Do respondents find the common modelling and parametric assumptions for the purpose of the EVE SOT and the NII SOT in Articles 4 and 5 clear enough and operationally manageable? Specifically, the EBA is seeking comments on the recalibrated lower bound for post-shock IR levels in the EVE SOT and NII SOT as well as on the use of a one year time horizon and a constant balance sheet with current commercial margins for new business for the NII SOT.

Respondents are also kindly requested to express whether they find an inclusion of market value changes in the calculation of the NII SOT clear enough.

➤ Article 4 (EVE SOT)

We find the provisions in article 4 “Changes in the economic value of equity (EVE)” to be sufficiently clear. We also find it operationally manageable since it is built on the article 115 of the current EBA GL (EBA/GL/2018/02), which is already implemented in the internal measurement system.

However, some clarifications are needed regarding the treatment of EUR positive changes in the currency aggregation. In particular, the 80% weight is applied to ERM II currency while it is not explicitly reported the weight to apply to euro positive EVE changes that, in our understanding, should be 50%.

We propose to modify the sentence “Positive changes shall be weighted by a factor of 50% or a factor of 80% in the case of Exchange Rate Mechanism - ERM II currencies...” as follow: “Positive changes, including euro, shall be weighted by a factor of 50%. A factor of 80% shall be applied only in the case of Exchange Rate Mechanism - ERM II currencies [...]”

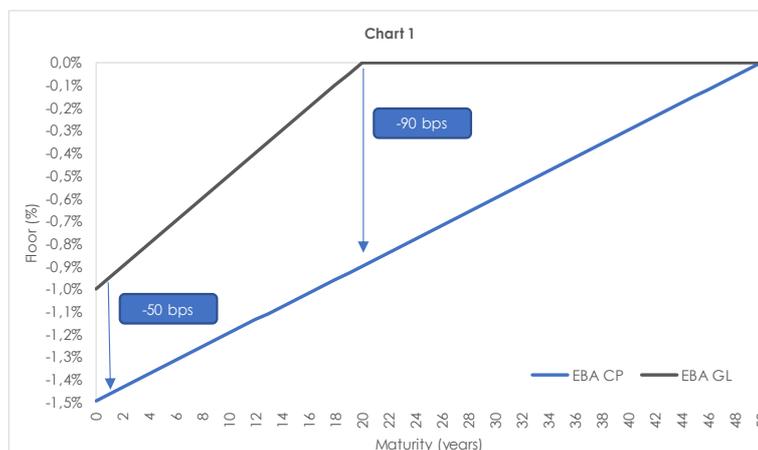
➤ Article 5 (NII SOT)

Regarding the NII SOT, we agree on the choice of the one-year time horizon and the constant balance sheet assumption, including current commercial margins for new business since it is in line with the current internal measurement system. However, in our opinion, some clarifications are needed regarding the meaning of “recently” for new commercial margin (i.e. last day, last month, last available data) and their treatment when calculating the NII sensitivity that should only reflect the changes of risk free interest rate and not the changes of commercial margins (i.e. the new commercial margins in the baseline scenario and in the shock scenario should not change).

In our opinion, the treatment of EUR positive changes in the currency aggregation that should be expressed explicitly in the Article 5.

➤ Lower bound for post-shock interest rates

The proposed post-shock floor has been lowered producing a **significant increase of the negative shocks up to 90 bps** (see the chart 1 below).



We understand the need to recalibrate the floor considering that, in some markets, the rates were below the current EBA floor (from -1% to 0% in 20 years).

However, in order to:

- avoid an increase of risk motivated only by the recalibration of the floor;
- avoid using a different floor from the one used in the 2021 QIS, that was adopted to calibrate the threshold for NII SOT;
- increase the results' comparability reported in the SREP exercises over time;
- avoid implausible low negative rates;

**we propose to keep unchanged the EBA Floor to the current -1% to 0% in 20 years.**

Instead, we suggest changing the rule provided in case “observed interest rates are lower than the post-shock interest rate floor” when, “institutions shall apply the lower observed interest rate.” This rule, if it were applied literally, implies the use of different rates for every maturity where the rate is below the floor, adding more operational complexity. Consequently, we propose to amend it applying the following formula only when some rates are below the floor (to make it clear, when all the rates are above the floor the -1% to 0% in 20 years it continues to be applied):

$$\text{Floor} = \text{Min}(-1,0\% + 0,05\% \cdot t ; \text{Min}(\text{Rate}_t) )$$

$\text{Rate}_t$  = zero coupon rate with maturity  $t$

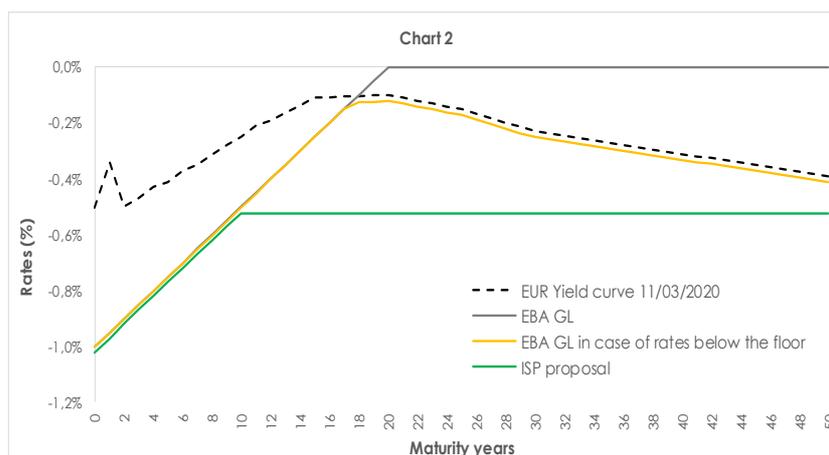
$\text{Min}(\text{Rate}_t)$  = minimum rate of the curve

$t$  = maturity expressed in years

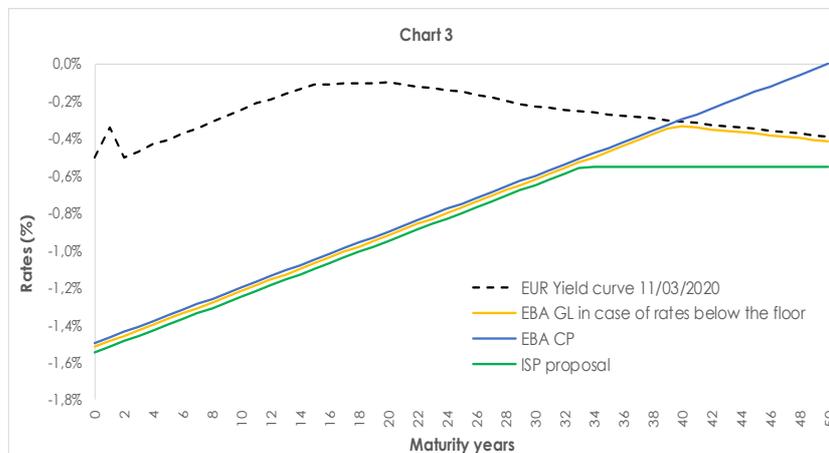
As shown in the following table 1, in the euro yield curve of 11/3/2020 rates for maturity greater than 20 years, are below the floor, while our proposed floor applies the minimum rate -0,50%, that in the example is the rate for immediate maturity.

yrs	Rate <sub>t</sub>	EBA GL	Proposed Floor
0	-0,50%	-1,00%	-1,00%
1	-0,34%	-0,95%	-0,95%
2	-0,50%	-0,90%	-0,90%
3	-0,47%	-0,85%	-0,85%
4	-0,43%	-0,80%	-0,80%
5	-0,41%	-0,75%	-0,75%
10	-0,25%	-0,50%	-0,50%
15	-0,11%	-0,25%	-0,50%
20	-0,10%	0,00%	-0,50%
25	-0,15%	0,00%	-0,50%
30	-0,23%	0,00%	-0,50%
35	-0,27%	0,00%	-0,50%
40	-0,31%	0,00%	-0,50%
45	-0,35%	0,00%	-0,50%
50	-0,39%	0,00%	-0,50%

In chart 2, we compare the EBA floor applying the minimum between the observed rate and the floor (yellow line) with our proposal (green line).



In chart 3 we compare the EBA floor in the Consultation Paper, in case of observed rate below the floor (yellow line) with our proposal (green line). We noticed that the new floor proposed by EBA is above the euro yield curve as at 11/3/2020.



➤ **Market value changes in the calculation of the NII SOT**

The definition of “[...] **instruments accounted at fair value**” is not clear. It is not clear what instrument shall be included (FVOCI, FVTPL, HFT) and how “fair value” changes should be calculated (full fair value – due to changes in all risk factors - or just the changes deriving from movements of interest rates curves). Besides, it is not clear if some future cash flows must be excluded from the computation of the fair value (for instance those which are already included in NII measure for the next 12 months).

Moreover, in our opinion, the fair value changes should not be considered in the NII since they are already factored in EVE measurement and their inclusion would create a difference from current managerial measures and accounting NII definition, which includes only interest income and expenses. **We propose to remove the paragraph b of Article 5.**

**Question 2**

**Do respondents have any comment related to these two metrics for the specification and the calibration of the test statistic for the large decline in Article 6 for the purpose of NII SOT? Specifically, do respondents find the inclusion of administrative expenses in metric 2 clear enough? Do respondents have any comment on the example on currency aggregation for metric 1 and metric 2?**

➤ **Metrics for the NII SOT**

We support Metric 1 proposal, because we believe it is simpler to manage by the risk-taking centers, easier to communicate to Top Management and more aligned to EVE metric, favoring the comparability between the two metrics.

At this regard, we remark that – during the RAF process – the limits setting should be made ensuring coherence between EVE and NII limits, so that actions taken to manage IRRBB may impact both measures without any other noisy factor. Having the thresholds set with the same EVE metric, it would be helpful in this process.

On the opposite, Metric 2 could be strongly affected by extraordinary events (M&A, pandemic ...) and multi-annual budget planning which are, in most of the cases, not related to the specific risk factor. For these reasons, we believe that this formulation would add an unwanted volatility to the indicator and moreover it would reduce the comparability among banks.

Furthermore, metric 2 also requires, for the currency aggregation process, data on administrative expenses in currencies different from euro, which may not be easily available.

Moreover, since the denominator is higher than the one in metric 2, the ratio of metric 1 results more stable.

➤ **Calibration of NII SOT**

In our view, there are four critical points in the calibration of the large decline based on the 2020 QIS results:

- 1) the calibration of the threshold has been done using two scenarios: the parallel up (scenario 1) and the parallel down floored with the current EBA Floor (scenario 2), limiting the size of the shock to about -50 bps. **Should the new floor (from -1,5% to 0% in 50 years) be applied, more institutions may become outlier since the shock used would be twice the magnitude of what was used in the QIS (-100 bps);**
- 2) the calibration of the threshold has been done considering the current low interest rate scenario. **Should the interest rate increase, more institutions may become outlier as consequence of a higher shock (-200 bps);**
- 3) the threshold has been calibrated on the **outcomes of the QIS, calculated by institutions according to the internal measurement system; this decision should have affected the thresholds' underestimation.**
- 4) the threshold for the large decline should be **set in order to be compatible with EVE SOT and**, to avoid that an institution may be compliant with the EVE SOT but not with the NII SOT.

In order to better clarify points 1 and 2, we provide the following example:

Suppose an institution has a NII sensitivity of -20 €/mln for a parallel down shock of -200 bps that, considering the current curve and the floor provided in the consultation paper, becomes about -100 bps. Suppose that the institution has a Tier1 capital of 1.000 €/mln and that the threshold is set to -2,5% for parallel down shock, considering the current EBA Floor. In this situation, the institutions NII SOT would be -2% (-20/1000) which is within the threshold. If the rates increase, the shock would be -200 bps and the NII sensitivity -40 €/mln thus the NII SOT would be -4% (-40/1000), hence implying a breach of the threshold. In conclusion, **the threshold should be set considering normal interest rate conditions, where the shock deploy its maximum impact** (for example based on the results of the unconstrained downward scenario of the QIS). Alternatively, we suggest using a new QIS where the new proposed floor (-1,5% to 0) is applied to obtain the impact of this for the calibration of the threshold.

Moreover, for the clarification of point 3 we propose the following example:

Regarding the 2021 QIS, we have noticed an inconsistency in the calibration of the threshold based on QIS results. Indeed, the results, as required by the instructions, are based on the internal measurement system and on the adoption of a currency aggregation internal methodology which may be different from the one used for the SOT purposes. This inconsistency may bring to an underestimation of the threshold. The table, reported below, shows a very simple example with two currencies (ccy 1 and ccy 2) having opposite  $\Delta$ NII exposure and where the IMS currency aggregation applies a 100% weight to positive exposure. Moreover, it is assumed that the SOT is based on Metric 1 and a Tier 1 capital of 1.000 €/mln.

	$\Delta$ NII	$\Delta$ NII/TIER1
ccy 1	-100	
ccy 2	75	
<b>SOT</b>	<b>-62,5</b>	<b>-6,25%</b>
<b>IMS</b>	<b>-25</b>	<b>-2,50%</b>
<b>TIER1</b>		<b>1.000</b>

In this example, there would be an underestimation of the threshold (-2,5%) which is based on the IMS. Its application would cause a breach of the SOT after using the EBA currency aggregation. In conclusion, **calibrating the threshold with QIS result may bring to an underestimated threshold due to the fact the QIS and SOT follow different methodologies.**

Regarding the critical point 4), in calibrating the threshold, it should be considered that institutions may be fully compliant with EVE SOT but not with the NII SOT. Indeed, an institution could have EVE and NII exposures largely contained within the operational limits for IRRBB but while, for example, the ratio [Max EVE loss/Tier1] is

7,5% (lower than the threshold of 15%), the [NII loss/Tier1] ratio could be 5% (higher than the threshold of 2,5%). This situation suggests that the institutions may not ever reach the 15% threshold (and for this reason will not be a threshold anymore) and may be induced to put in place hedging strategies only for the purpose of being compliant with both the threshold. Besides, EBA should consider that the QIS is calibrated with reference to the exposure of the institutions as at 31/12/2020 and not to the potential exposure that institutions may reach according to the internal operational limits.

➤ **Currency Aggregation**

As for the currency aggregation examples, we believe that examples with exposure in EUR being positive should be reported for better understanding the process and, as stated in answer to question 1, removing any doubt on factors to be applied on EUR exposures.

**Question 3**

**Do respondents consider that all the necessary aspects have been covered in the draft regulatory standard? Do respondents find the provisions clear enough or would any additional clarification be needed on any aspect?**

We would like to point out that the management of the two thresholds (NII SOT and EVE SOT) will be influenced by the introduction of the new accounting framework for macro fair value hedge (currently under construction) which will introduce further constraints to the management of IRRBB. So, we ask for the entry into force date of the new RTS to be aligned with the one for the new accounting framework.