INTESA ■ SANPAOLO

FINANCIAL AND MARKET RISK DEPARTMENT

The Fundamental Review of the Trading Book

Response to EBA Consultation on RTS on requirements that an internal methodology or external sources used under IMA DRC model are to fulfil for estimating PD and LGD

22/10/2020

Contents

1. Executive summary

In January 2019, Basel Committee on Banking Supervision (BCBS) finalised and published its standards on "Minimum Capital Requirement for Market Risk"[1]. The text replaces the previous Minimum Capital Requirements for Market Risk in the global regulatory framework, which are transposed in the EU via Regulation (EU) No 575/2013 (Capital Requirements Regulation – CRR).

It specifies that one component of the capital requirement under the IMA is the Default Risk Charge (DRC): it aims to capture the default risk for positions in traded debt and equity instruments included in IMA trading desks. Therefore, in order to simulate the default of issuers in the IMA DRC model, estimates of the default probabilities (PDs) and losses given default (LGD) of the issuers and issuances of these trading positions are needed.

EBA is mandated to develop draft Regulatory Technical Standards (RTS) specifying the requirements that an institution's internal methodology or external sources are to fulfil for estimating PD and LGD. To this purpose, on 22nd July 2020 EBA launched a consultation on draft RTS on this topic.

These Regulatory Technical Standards are one of the key deliverables included in the roadmap for the new Market and Counterparty Credit Risk approaches. They set out two approaches, that institutions are required to use for determining requirements that an internal methodology or external sources used under IMA DRC are to fulfil for estimating PD and LGD.

Considering the relevance of these topics within the revisited framework to compute own funds requirements for market risk, Intesa Sanpaolo (hereinafter, the Bank) would like to participate to the Consultation phase proposed by EBA on the aforementioned topic.

---

[1] BCBS d457, Minimum capital requirements for market risk, January 2019 (rev. February 2019)

2. Requirements that an internal methodology or external sources used under the internal default risk model are to fulfil for estimating default probabilities and losses given default

Q1. What would you consider to be the main challenges and most time consuming steps involved in using the IRB approach to be able to assign a PD and a LGD to a trading book issuer and the corresponding financial instrument, where such issuer is covered by the existing IRB permission, but no PD or LGD is immediately available under the IRB approach (i.e. they need to be assigned based on the existing IRB approach)? Based on this assessment, please indicate how much time you expect is needed for an IRB approach to assign a PD and a LGD to a specific trading book issuer.

As specified in article 325bp CRR II Regulation, institutions that have received permission to use the IRB approach should use it for all their issuers and issues in the scope of default risk charge. However, in practice, IRB approach only covers a certain scope of obligors / facilities for which PD / LGD estimates are available in the IRB approach (i.e. in the case of Trading Book positions held with traded intent that could change on a daily basis).

Therefore, PD and LGD from external sources will, in many cases, be the only estimates available: to these purpose, institutions (even those with an IRB permission covering relevant exposure classes and rating systems) should be allowed to temporarily use external sources.

This approach could imply some issues.

* From one side, for institutions could be extremely burdensome to retrieve default probabilities IRB-based for the whole set of issuers and issuances (especially for heterogeneous portfolios);
* For the other side, there may be operational challenges (in terms of processes / workflow) in order to associate IRB / external PDs [LGDs] values to issuers and issuances depending on availability. For example, when institutions' portfolio exposure covers several issuers – which could change their PD value over time – might be challenging to switch between IRB / external PDs [LGDs] whenever the firsts are not available anymore.
* Market information are usually timelier than IRB model estimations, as a consequence default charge will be often related to a fallback solution external source or obsolete IRB information.

Q2. What possible approach – other than the use of external sources as proposed in these RTS – could be considered until a PD and a LGD are calculated under the IRB approach for such issuer and financial instrument?

Intesa Sanpaolo believes that the use of external sources could be the most valuable alternative when IRB PD [LGD] values are not available. Usually public sources are timely and suitable for market risk measurement.

Q3. Could you please describe how PDs are determined for the purpose of the current IRC charge (Article 372 and following of the CRR)? Please specify, whether PDs are derived from internal sources and/or derived from external sources and what the predominant source (internal or external) currently is?

To the purpose of the current IRC charge, Intesa Sanpaolo determines PDs only from external sources. In particular, migration and default probabilities are historical and they are obtained from Moody's 1-year transition matrices published annually. Two matrices are in place: sovereign matrix and corporate / financial matrix. Both the matrices are observed on a more than 30-years window (since 1983). They are published annually and, if necessary, they are internally updated to obtain a macro grade matrix starting from a micro grade matrix and to manage the withdrawn rating probability.

In addition, the transition matrices used as input for the calculation of the measure have been amended in order to make them coherent with the article 372(a) of the CRR and the guidelines in the Article 65 of EBA Draft RTS[2]. Given article 372(a) of the CRR, a non-negative risk sensitive PD has been introduced for all issuers in the IRC computation.

---

[2] EBA 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 internal models for market risk and assessment of significant share under points (b) and (c) of Article 363(4) of Regulation (EU) No 575/2013 (November 2016).

Q4. What are your views with respect to alternative internal methodologies (i.e. IRB equivalent, but different from the approach proposed here) that could be developed to derive PDs under these RTS? Are there any particular aspects and issues regarding trading book dynamics that you would like to highlight?

In this framework, a premise is that the Bank believes that the use of external sources to estimate PD values for issuer and issuances could be the preferred solution. However, also in this case, there may be potential issues to be taken into account. Indeed, Data Provider (i.e. external rating agency) might made available PD values on a macro-field level (i.e. corporate / government) while in RTS is specified that those values should be for each issuer / issuances in perimeter. Hence, also applying the fallback approach, could be challenging to retrieve data with a sufficient level of granularity.

Q5. Could you please describe how LGDs are determined for the purpose of the current IRC charge (Article 372 and following of the CRR)? Please specify, whether LGDs are derived from internal sources and/or derived from external sources and what the predominant source (internal or external) currently is?

To the purpose of current IRC charge, Intesa Sanpaolo determines LGDs according to a static approach, depending on issuance seniority (80% for subordinated and 60% for senior) for any kind of issuer sector. Therefore, to this scope (similarly for PDs) the Bank applies only external sources.

Q6. What are your views with respect to alternative internal methodologies (i.e. IRB equivalent, but different from the approach proposed here) that could be developed to derive LGDs under these RTS? Are there any particular aspects and issues regarding trading book dynamics that you would like to highlight?

The same considerations highlighted in Q4 are still valid also in this framework.

Q7. Do you have any additional comments on the general approach?

Intesa Sanpaolo believes that further considerations could be made substantially about two topics.

- The application of 0.03% floor to PD values. To this purpose, the Bank deems that the current 3bps floor on Sovereign might be removed and, from empirical analyses, we have estimated that the floor should not be higher than 1bps. In addition, any such floor would be against the consistency principle between trading and banking book and therefore should await the overall review of the sovereign risk. Similar considerations could be made also for corporate exposure.

  Furthermore, the 3bps floor on PD for IMA DRC is overly conservative, in particular for sovereigns and will become market making activities on sovereign debt as uneconomic. Finally, the prescribed floor is not risk sensitive and it may lead to ambiguous impacts on DRC metric: indeed, in this case, AAA rated positions are theoretically similar to BBB rated ones, making the latter more attractive in economic terms.

- The potential absence of a *level playing field* between IMA and SA framework. Indeed, empirical analyses clearly show that *ceteris paribus* the latter is much more incentivizing than the first, in particular for those banks with a portfolio concentrated on high rated and short-term positions. Indeed, for standard approach, to account for defaults within the one-year time horizon the JTDs for all exposures are scaled by a fraction of year as well as a rescaling factor is provided for highest credit quality positions. However, these adjustments are not considered in IMA framework.