

Consultation Paper (EBA-CP-2017-02)

Draft Regulatory Technical Standards (RTS) on the specification of the nature, severity and duration of an economic downturn in accordance with Articles 181(3)(a) and 182(4)(a) of Regulation (EU) No 575/2013

[Intesa Sanpaolo S.p.A.](#) welcomes EBA Draft Regulatory Technical Standards (RTS) on the specification of the nature, severity and duration of an economic downturn.

During the last three months, we have attended meetings organised by the Institute of International Finance (IIF) in order to work together on sharing our point of view regarding the EBA CP on Downturn (EBA-CP-2017-02). We totally agree with the contents reported in the IIF document and fully endorse it. For this reason our individual response to the Consultation does not consist in a complete list of answers which you will receive directly from the IIF, but it is focused on highlighting a few topics which in our opinion are of particular importance.

IIF argues in several points against taking the worst of each single LGD component, e.g. :

- **Q5:** *“using the year of realized losses would mix defaults from different years potentially confusing the results”;*
- or **Q10:** *“It is unclear the rationale behind combining worst case events that occurred at different moments in time in the past into one worst-worst case scenario in the future”.*

We totally agree on it and think that this is the single most important contribution. Furthermore, we believe that the same argument can be made about the choice of the downturn period jointly for PD and LGD (we will ignore CCF for sake of simplicity, but the argument can be easily extended).

After all, PD and LGD can be regarded as components of the credit loss, which is our ultimate target variable, and combining the worst of the 2 components can easily lead to overstate the potential credit losses. This is in contrast with the rationale stated in EBA CP that *“in certain cases downturn LGD/CF will need to be calculated even if no correlation is evidenced between default rates and recovery rates”* (page 6), which we believe is flawed.

As a consequence, the downturn period should be identified with reference to credit factors only, in contrast with EBA requirements. Even common sense tells us that losses arise if we have low recoveries on a high number of defaults, so we should be concerned by what happens in the recovery process of a bad default year, and less so by low recoveries on a small number of exposures. You may add some conservative adjustments, in order to stress the PD-LGD correlations, but taking the worst case of both is clearly overstating the risk. This is a conceptual point, and it can be applied in different model contexts. In the simplest case, it can be argued that you should take as the downturn period the one with the highest default rate, and then measure the downturn LGD with reference to the defaults opened in that period. But you can also model downturn LGD in different ways, maybe because of data shortage, for example by referring to external economic factors. What is important, is that those economic factors are the same for PD and LGD.

In addition, we believe that the suggested approach might potentially allow for significant subjectivity in the interpretation. Depending on which macroeconomic factors are used, banks will arrive at vastly different outcomes. We underline that this approach will not be able to reduce RWA variance, but potentially increase it, because the proposal relies heavily on expert based choices (e.g. identification of economic factors and economic scenarios, addressing of margin of conservatism, etc.).

We think that the definition of the Downturn period should be the same within a jurisdiction: different banks in the same jurisdiction should use the same downturn period to develop their own downturn model. Only by avoiding expert based choices RWA variance can be reduced.