

INTESA SANPAOLO RESPONSES TO:

EBA-CP-2018-07

Draft 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

And

EBA-CP-2018-08

Guidelines for the estimation of LGD appropriate for an economic downturn ('Downturn LGD estimation')

22 June 2018

General remarks

Intesa Sanpaolo welcomes the opportunity to comment on the European Banking Authority (EBA) second *Draft RTS on the Specification of the Nature, Severity and Duration of an Economic Downturn*, as well as the *Guidelines for the estimation of LGD appropriate for an economic downturn (“Downturn LGD estimation”)*.

Intesa Sanpaolo continues to support efforts to improve and ensure the credibility of Risk Weighted Assets (RWA) calculations and reduce unjustified RWA variance. We share the EBA’s view as presented in the Guidelines that “the strength of internal models lies in the ability of institutions to model on institution specific data, which ensures a high degree of risk sensitivity and constitutes an important characteristic of capital requirements to be maintained.”

Our work has been based on some issues already highlighted within previous EBA’s Consultation on its draft *Regulatory Technical Standards (RTS)*, to which we participated both on stand-alone basis and together with the *Institute of International Finance (IIF)*. Also in this new consultation papers we shared our views with the *Institute of International Finance (IIF)* and we completely support its response. We recognize that many positive changes have been introduced with respect to the previous text but we have identified some technical items that we feel warrant some further consideration.

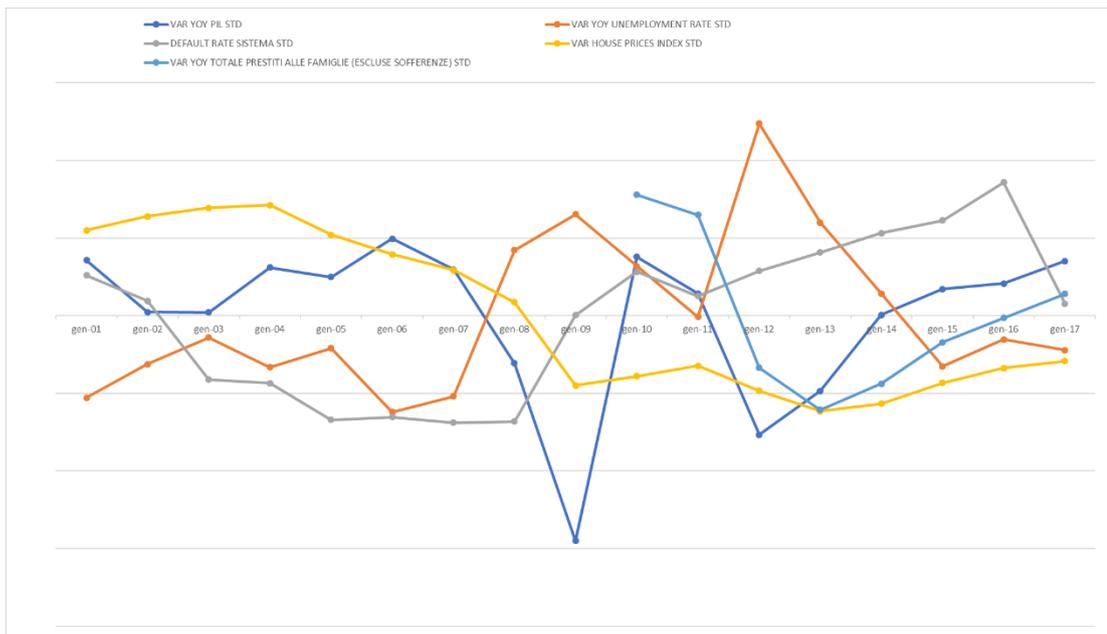
The following pages contain our detailed responses to the two questions in the RTS, and each of the ten questions posed in the Guidelines; before the answers, we have recapped below some of the most significant themes in order to encompass some aspects not always included within the specific questions:

- The **list of indicators** at Article 2, Paragraph 1 of the RTS is too long and determines some concerns about the workability of the approach (mandatory list). Even if all of them appear reasonable, the list should be reduced in order to ease the analysis: the need to analyze all of them seems too burdensome for the institution. The problem is not only caused by the availability of the information for all the indicators (i.e. credit losses) but by the consequence that, by using many factors, it is more likely to have many peaks and therefore many impact assessments to be performed according to GL prescriptions. Proposal: either to reduce the list of indicators or to make optional the analysis of the entire list.

For the economic/credit factors applicable to each jurisdiction it would be possible to directly provide the data sources in order to ensure harmonization and not to create differences in these objective measures.

Moreover, if the peaks / troughs of economic factors are not reached simultaneously but they are correlated, the RTS assigns them to the “same downturn period”. The risk of the subjectivity in the interpretation of the results is very high, also due to the fact that the RTS requires not defining an excessively long downturn period. Proposal: in order to avoid discretion within the jurisdiction, the RTS should better clarify how to assign the factors to the same downturn cycle and eventually defines a cap to the overall duration. Solution for a complete harmonization: RTS should directly define the downturn periods for each listed economic factor and each jurisdiction.

The following graph based on some indicators proposed by the RTS well illustrates how the usage of so many indicators as well as the data availability and the subjectivity in interpreting them can go in an opposite direction than the greater harmonization:



- **Multiple Downturn Periods:** we think that, in case of multiple downturn periods caught by various economic indicators, the Downturn quantification should be performed not by choosing “the worst of the worst” but by making an average of the different downturn impacts because in the Regulation (e.g. CRR IV) it is not written that Downturn conditions should correspond to an extreme “stressed” scenario.
- **Type of exposure vs. calibration segment:** the two definitions, respectively provided by the RTS and GL, should be better defined and harmonized also with respect to the definition of “class of exposure” of the CRR IV. The link with the calibration segment has to be clearly indicated. In case of economic factors related to real estate exposures vs. unsecured exposures within the same class of exposure (e.g. Corporate) an example could better clarify: a) how to deal with peaks and troughs deriving from different downturn periods (once the maximum level has been detected within each calibration segment); b) how to compute the downturn impact; c) how to apply the downturn impact to the long run average LGDs estimated by grades / pools where the latter are even more granular than the simple secured vs. unsecured differentiation (due to the other risk drivers). The proposed policy in the GL allows quantifying downturn LGD estimates at a more granular level than long-run average LGD estimates where this provides more appropriate final downturn LGD estimates. How to combine this aspect with the above issue on type of exposure vs. calibration segment?
- **Impact assessment vs. reference value approach:** the combination of the two analyses seems too burdensome and useless in particular in case of downturn estimation based on observed losses (Section 5 of the GL). The impact assessment has a clear framework and is strictly related to the definition of the economic factors. The same does not hold for the reference values which are referred to the peak of the losses and represent a floor difficult to compare with the model results since the peak of the losses cannot be linked to a macroeconomic distress (downturn); for example, the peak of the losses can be determined by an extraordinary event such as a massive credit sale which is the result of managerial policy to reduce NPL likely not performed in a downturn situation but more result of previous downturn situations or regulatory constraints (reduction of NPL ratio). Reference values approach could be disregarded with the new framework based on the impact assessment since it can be burdensome and at the same time useless for the institutions to justify

potential misalignments not directly caused by a macroeconomic distress. According to our opinion it is not necessary to have two backtestings of the internal downturn model and the reference value should be, at most, adopted in place of the third option (20% add-on) proposed in Section 7.

- **Impact assessment:** we support the initiative to introduce an impact assessment leaving flexibility to institutions for the estimation of an internal Downturn model, but we have some issues on the implementation of the approach:
 - **realized LGDs:** we do not agree to analyze realized LGDs on all defaults including open cases recoveries since this framework would determine an estimation based on another estimation with substantial impact on the results. The issue about the vintage of default vs. vintage of closed recovery process is critical and results can be biased, for example, by extraordinary events (credit sales). One idea can be to use the vintage of default moved ahead by the average time of recovery (year of cash flow).
 - **annual recoveries:** we do not support the analysis of total recovery observed and we think more clarifications are necessary on this issue. According to our opinion a ratio would be more meaningful than an amount and the ratio should be expressed over the stock of exposure at the beginning of the year considered.
 - **time in default:** a more appropriate measure for the downturn impact should be the average time of recovery, where the timings are weighted by the recoveries as a financial duration.
- **Model component:** in case of LGD models developed according to a model component approach (normally cured vs. not cured) it is not clear how to deal with a potential overall negligible downturn effect. Let's suppose, for example, that the RTS criteria identify a downturn period where the not cured LGD is higher than the long run average but the cure rate is higher than the long run average. The resulting combined effect determines in this case an overall LGD not higher than the long run estimate. Should in this case the institution consider only the worsening effect of the not cured LGD or vice-versa can justify a downturn adjustment equal to zero?
- **20% fixed add-on:** the proposal of a 20% fixed add-on (Section 7) in case data unavailability and impossibility to estimate a downturn impact is too penalizing and it is not clear how it has been estimated. We feel that such add-on is so high in order to prevent institutions from adopting it in place of developing internal Downturn models but the underlying rationale is not clear. We feel that many portfolios could be hit by this proposal, at least all the *Low Default Portfolios* or in general all the *Low Data Portfolios* with substantial impact on capital requirements. Finally, we deem that the 105% cap is not reasonable since there is not a clear rationale for which the Downturn loss should overcome 100%.
- **MoC:** we think that the MoC, in particular the one referred to Category C of general estimation error, should be computed only at model level and should encompass all the potential estimation errors coming from the various components (such as the downturn adjustment): **the MoC C should measure the dispersion of the estimated LGD** (inclusive of the downturn effect) with respect to the observed values and therefore a unique quantification of all the estimation errors should be sufficient. The unique quantification of MoC at model level should be clearly stated in the GL so to avoid potential misunderstandings.

- *Response to the Draft Regulatory Technical Standards 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*

Q1: Do you have any concerns around the workability of the new approach (e.g. data availability issues, burden on the analysis, split between the definition of the economic downturn and its impact on the internal loss data)?

The list of indicators at Article 2, Paragraph 1 is too long and determines some concerns about the workability of the approach (mandatory list). Even if all of them appear reasonable, the list should be reduced in order to ease the analysis: the need to analyze all of them seems too burdensome for the institution. The problem is not only caused by the availability of the information for all the indicators (i.e. credit losses) but by the consequence that, by using many factors, it is more likely to have many peaks and therefore many impact assessments to be performed according to GL prescriptions. Proposal: either to reduce the list of indicators or to make optional the analysis of the entire list.

For the economic/credit factors applicable to each jurisdiction it would be possible to directly provide the data sources in order to ensure harmonization and not to create differences in these objective measures. Moreover, if the peaks / troughs of economic factors are not reached simultaneously but they are correlated, the RTS assigns them to the “same downturn period”. The risk of the subjectivity in the interpretation of the results is very high, also due to the fact that the RTS requires not to define an excessively long downturn period. Proposal: in order to avoid discretion within the jurisdiction, the RTS should better clarify how to assign the factors to the same downturn cycle and eventually defines a cap to the overall duration. Solution for a complete harmonization: **RTS should directly define the downturn periods for each listed economic factor and each jurisdiction.**

The split between the definition of the economic downturn and its impact on loss data does not seem to increment the burden on institution if the previously indicated adjustments are introduced.

Finally, time series too long, for example before Euro, could reduce the representativeness of the downturn and the availability of different time series among jurisdictions could increase the unjustified variability: we think that the 20 years requisite should be clearly adapted in first adoptions so **to consider the Euro introduction as a structural break** as well as to deal with indicators whose availability does not cover the entire period (for example because the National Bank started the reporting of that indicator after the required starting point).

Q2: Do you see any issues of applicability of this RTS for estimating conversion factors appropriate for an economic downturn identified in accordance with this RTS?

No, but the CF are not treated in the GL and therefore are still an open point for the quantification of the downturn adjustment. It is clear that the impact assessment on the LGD side is not suitable for CF as well as the fact that an evident relationship between macroeconomic factors and CF is not always detected within internal data. Since the GL tackles for the first time the downturn component in an exhaustive way it seems to be a “lost opportunity” to deal also with CF leaving the institutions with a lot of subjectivity in the estimation of the downturn component as well as the competent authorities without a clear guidance on how to validate it.

- ***Response to the draft Guidelines for the estimation of LGD appropriate for an economic downturn ('Downturn LGD estimation')***

Question 1: Do you think that additional guidance around the estimation of LGD in-default, which reflect downturn conditions, is needed? If yes, could you provide examples of sound methodologies for transposing downturn LGD estimates from performing to non-performing exposures?

The proposal to adopt the performing downturn LGD estimation also for the non-performing exposures is shareable. The only exception can be represented by different samples due to peculiar exclusion for defaulted asset model: in this case the analysis should be performed again but still neglecting the reference dates ("vintage" component) which could sensibly increase the complexity of the downturn quantification.

Question 2: Do you share the concern that the proposed policy in paragraph 15 could create an undue burden if applied to every downturn period identified? If yes, in order to better balance the accuracy of the estimations and its operational complexity what evidence should be provided by institutions in order to justify the exemption of identified downturn periods from the proposed policy in paragraph 15?

Yes, the analysis should be performed coherently with the available historical series for the LGD estimation and taking into account potential structural breaks (such as for example the introduction of the Euro within the Eurozone). The rule of the twenty years could be adapted according to these intuitive matters in order to avoid an undue burden on institutions. Finally, we think that, if different downturn periods result from the economic factors analysis, the rule should not be "the worst of the worst" but an average of the different downturn periods.

Question 3: Do you agree with the proposed level of downturn LGD estimation set out in paragraph 14? In particular, do you support the concept that the downturn LGD estimates of different calibration segments could be based on different downturn periods? Is the policy on the level of downturn LGD estimation as well as the relation between the level of downturn LGD estimation and the relevant downturn periods sufficiently clear?

We think that the proposed level of the downturn LGD estimation and the relationship with the downturn periods (i.e. the economic factors) should be better explained. A critical aspect is the relationship between "type of exposure" introduced in the RTS, the "class of exposures" defined in the CRR IV and "calibration segment" introduced by the GL for downturn LGD estimation: the definitions should be better defined and harmonized and the link has to be clearly indicated. In case of economic factors related to real estate exposures vs. unsecured exposures within the same regulatory segment (i.e. Corporate class of exposure) an example could better clarify: a) how to deal with peaks and troughs deriving from different downturn periods (in the same class of exposure); b) how to compute the downturn impact; c) how to apply the downturn impact to the long run average LGDs estimated by grades / pools where the latter are even more granular than the simple secured vs. unsecured differentiation (due to the other risk drivers). Granularity: the proposed policy in the GL allows to quantify downturn LGD estimates at a more granular level than long-run average LGD estimates where this provides more appropriate final downturn LGD estimates. How to combine this aspect with the above issue on type of exposure vs. calibration segment?

Question 4: Do you consider the description of the approaches to be sufficiently clear?

The description of both the “haircut” and the “extrapolation” approaches should be integrated with some further practical examples for a clear comprehension.

Question 5: Do you agree to the limitation of approaches for quantification of downturn LGD estimates? If not, which other approaches should be considered? Would you prefer the alternative policy considered – if yes how should a minimum MoC be established in this case?

Yes, we agree but we ask for more details on the alternative approaches provided in Section 6. We do not have specific opinions on further alternative policies already disregarded by the EBA.

Question 6: Do you expect that the total exposure amount or share which is treated with the policy proposed in Section 7 is material?

We think that this option can have a direct impact on LDP as long as the IRB approaches are permitted. In general, our opinion is that the 20% add-on is too conservative and not justified. Moreover, it is not clear how it has been estimated since a subjective measure is clearly dangerous on such impacting topics. We understand that the idea is to provide a strong incentive to the institutions for an internal estimation of the downturn adjustment but we think that, in some cases such as LDP / low data portfolios, the unavailability of data is a crucial aspect. Finally, we deem that the 105% cap is not reasonable since there is not a clear rationale for which the Downturn loss should overcome 100%.

Our proposal is to replace this 20% add-on with the reference value approach which can instead be disregarded as a benchmark option in case of downturn adjustment computed coherently with prescriptions of Section 5 and 6.

Question 7: Do you have specific examples of types of exposures which will fall under the policy proposed in Section 7?

LDP portfolios can be a clear example.

Question 8: Do you agree to require a minimum MoC quantified via a fixed add-on to the long-run average LGD? If not, which of the alternatives should be considered? Do you see reasons for differentiating the fixed add-on according to exposure classes?

As introduced in Question 6, we think that the fixed 20% add-on is too penalizing and not justified. We understand that the idea is to provide a strong incentive to the institutions for an internal estimation of the downturn adjustment but we think that, in some cases such as LDP, the unavailability of data is a crucial aspect. Our proposal is to replace this 20% add-on with the reference value approach which can instead be disregarded as a benchmark option in case of downturn adjustment computed coherently with prescriptions of Section 5 and 6. The adoption of the reference value approach can also allow differentiating the floor among exposure classes.

Question 9: Do you agree to the minimum MoC as the max (0, min(20%, 105% - LRAVLGD))?

No, as explained in Question 6 and 8.

Question 10: Is the policy regarding the reference value sufficiently clear? Alongside with the potentially limited applicability of the reference value to the downturn LGD estimation according to paragraphs 18-19, for what reasons could the reference value feasibly be omitted? Do you agree to the proposed clarification of the role of the reference value?

The policy on the reference values has some issues to be clarified:

- The average LGD from the two worst years by facility grade / pool can be subject to the low number of facilities. This issue is particularly critical in particular for some segments and the result in that case can be more determined by the low number of facilities than by effective peaks of loss rates. The layer of computation of the reference values should be reconsidered to adequately consider this aspect;
- It is not clear how to deal with correlation structure among the intermediate parameters;
- In case of model component (typically cure rate and LGD for “cured” and “not cured”) each component should be analyzed with the perspective of the two worst years over 20 (10) years. First question: should the two worst years be computed according to each axe of analysis (“cured” losses, “not cured” losses, probability to be cured) or should it be one for all determined by the analysis of the “not cured” losses? In this case how the different components should be considered altogether also taking into account the correlation structure above introduced?
- How to deal with some extraordinary events (such as massive credit disposal) which can strongly influence the reference values but are not result of a downturn situation and are also potentially mitigated within the LGD calibration (see *EBA GL on PD estimation, LGD estimation and the treatment of defaulted exposures*).

EBA clearly indicated that reference values should be considered as a “soft floor”; nonetheless, it is evident that institutions have the burden of proof to demonstrate potential misalignments with internally obtained results. This consequence appears not appropriate, in particular by considering the new framework proposed by the EBA with the “impact assessment”. The combination of the two analyses seems too burdensome and useless, in particular in case of downturn estimation based on observed losses (Section 5 of the GL). The impact assessment has a clear framework and is strictly related to the definition of the economic factors. The same does not hold for the reference values which are referred to the peaks of the losses and represent a floor difficult to compare with the model results since the peak of the losses cannot be linked to a macroeconomic distress (downturn); for example, the peak of the losses can be determined by an extraordinary event such as a massive credit sale which is the result of managerial policy to reduce NPL likely not performed in a downturn situation but more result of previous downturn situations or regulatory constraints (reduction of NPL ratio).

Reference values approach could be disregarded with the new framework based on the impact assessment since it not necessary to have two backtestings of the internal downturn model. As introduced in answers to Questions 6 and 8, reference value approach can instead substitute the approach proposed in Section 7 of the fixed add-on for the cases with no internal data for downturn adjustment estimation.