

11 September 2015

Bank for International Settlements
Centralbahnplatz 2
4051 Basel
Switzerland

Subject: Response to the BCBS Consultative Document on Interest Rate Risk in the Banking Book

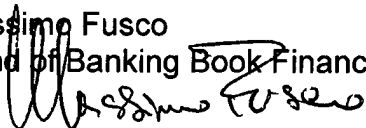
Dear Sir/Madam,

Intesa Sanpaolo Group (ISP) is grateful to have the opportunity to comment on the Consultative Document (CD) on Interest Rate Risk in the Banking Book (IRRBB).

ISP welcomes the constructive dialogue with the Basel Committee to strengthen the current regulatory framework and is willing to cooperate for further developments on IRRBB.

Yours faithfully,

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1. ISP supports a “true” Pillar 2 approach while being aware that standardization may produce misleading results

ISP believes that the most appropriate option for the measurement and management of IRRBB should be a true Pillar 2 approach where banks are allowed to use, with supervisory agreement, their own internal measurement systems (IMS). For this reason we disagree with the Pillar 2 approach proposed in the CD which departs from a genuine Pillar 2 approach, due to the fact that it makes use of the Pillar 1 standardized calculation for disclosure, benchmarking and as a fall back solution. The excessive standardized framework, being a benchmark and a floor to the capital banks should hold, acts as a constraint on banks' internal measurement.

A level playing field might be achieved by setting guidelines and principles on some methodological features (such as scenarios definition, the need to include/exclude equity and/or credit spread, the overall duration for NMDs), thus avoiding the imposition of a one-size-fits-all standardized framework. While being in favor of standardization in metrics, principles and scenarios, some concerns arise from the excessive standardization in models and parameters.

Banking book products and exposures are substantially different from trading book ones. There is no market consensus in prices and different jurisdictions have different types of products. Products that have the same name may incorporate totally different financial characteristics. Even mortgages, that are one of the most common banking book products, can show very different features in different jurisdictions (interest rates may start with a fixed schedule and then turn into a floating one, different kind of indexation, composition of the installments, and so on). Furthermore, customers can behave differently from bank to bank and from one jurisdiction to another. Some customers seem to be more sensitive to a change in market rate; others show a much lower reactivity even within the same customer segmentation.

Given its prescriptive nature, there is the fear that the *proposed standardized approach will not be able to adequately capture the peculiarities of the bank's portfolio and, in doing so, to reflect the bank's actual level of interest rate risk*. As a consequence, standardization would lead to a lower precision in IRRBB estimation, setting aside an amount of internal capital that may either underestimate or overestimate the appropriate level of risk. In a case of underestimation, it might represent a potential threat to the overall banking stability; on the contrary, in a case of overestimation, banks would be required to hold an excessive amount of capital that would likely produce a reduction in their lending capacity.

Pushing ahead with the standardized approach will not only lead to a potentially distorted view of risk, but will also fail to consider differences in how banks manage their IRRBB in terms of hedging strategies, alignment to different accounting standards, and the use of proprietary internal models.

Banks over the years have internally developed their own risk modelling and risk representation has been followed by an active management of the banking book portfolio. All the complexities should be already caught by the internal measurement systems: particularly in cases involving the most sophisticated banks who would be penalized if the adequacy of their internal systems couldn't be acknowledged during the process put in place by the Supervisor (SREP).

The fact, for example, that internal models couldn't be fully recognized *may lead to discrepancies between the regulatory representation and the ALM practices*. Making a distinction between requirements set out only for supervisory purposes and requirements/guidelines set out for internal risk management, unfortunately, is likely to be more of a theoretical exercise: it could be extremely difficult for banks to withstand a situation in which internal risk measures diverge significantly from regulatory measures, and it will be even more so if/when those measures will lead to a Pillar 1 capital charge. In other words, the regulatory model will impact on banks' choices for internal models and ultimately on banks' strategies and business models.

2. A “true” Pillar 2 allows for the use of internal models and estimations with supervisory agreement

Given the heterogeneity among international banks in terms of products, nature of underlying risk, processes for monitoring /measuring risk and management practices, ISP Group supports the proposition of a “true Pillar 2 approach” to ensure that banks have a sound risk management framework in place as well as robust control and governance processes that are commensurate to their size, complexity, business model and risk profile (Principles 1 to 7). The proposal to strengthen the IRRBB governance framework contained in the BCBS Consultative Document's Pillar 2 principles - as well as inside the new EBA Guidelines - moves in this direction.

However, in a true Pillar 2 framework, banks should be given the full flexibility to use their own internal measurement systems (IMS) without restriction in models and parameters.

The new IRRBB framework, while declaring the possibility of using some internal measures for the calculation of interest rate risk in the Banking Book, doesn't seem to take it into consideration, both in the Pillar 1 and in the enhanced Pillar 2 framework:

- Boundary constraints which highly affect the possibility to use in full the internal models developed for NMDs
- Other models should be included to give a proper representation of the IRRBB risk (sight loans, expected default, core prepayment etc.) and should be defined by the single institution according to a proportionality and relevance principle
- Prepayment assumptions should be extended to floating products as well as to non-retail customers; the “core prepayment”— one which is not directly linked to changes in interest rates - should be properly included using internal models.

As for Pillar 1, due to the definition of a standardized methodology, internal models adoption is limited to the prepayment/redemption rates' estimation and - subject to strict constraints - to the core NMDs' scheduling over time. This is not fully consistent with what has been already done for other types of risks (credit risk, market risk, operational risk) where standardized and advanced methodologies coexist. As for Pillar II, the use of internal models is limited by the fact that a fall back solution, based on the standardized framework has to be, in any case, put in place.

In the IRRBB context, the internal model seems to only be allowed if it is more conservative. In other words, there is no incentive to develop any kind of internal framework. Some constraints and limitations of the standardized proposed approach are highlighted below.

- **NMDs**

The proposed standardized treatment of NMDs is far too restrictive and does not enable a realistic representation of the interest rate sensitivity of these deposits. In the Basel framework, the “core” cash flow slotting can follow a *uniform* (deposits linearly allocated up to six years) or a *discretionary approach*. The latter allows for some internal estimation usage, however the internal estimation is very limited due to the presence of strict constraints:

1. The bank’s discretion is only applied to the portion of deposits beyond *the implied cap*: 60% for transactional retail deposits, even less for non-transactional retail deposits and for corporate ones;
2. The portion to be slotted is limited both in terms of *maturity (6 years) and average life (3 years)*: internal models are allowed if more conservative than the standard one (e.g. exponential decay versus linear one, a shorter maturity, a portion of “core” transactional NMDs even lower than 60%).
3. The fact that the entire *interest rate sensitive* portion is *allocated in the o/n bucket* is also questionable given that it does not take any kind of viscosity/delay in customer rates *repricing* in case of market rates changes into consideration.

All the above mentioned constraints lead to a single and unique representation: the internal model can be recognized just in case it is more conservative compared to the standardized one.

If the main goal of modelling NMDs is to better reflect customers behaviour and product specificities in order to set up the appropriate risk management strategies even in a medium-long term horizon, banks have to be free in adopting the representation that better suits their own clients/products features.

ISP recognizes the utility of *introducing some constraints in terms of risk* (e.g. overall duration/sensitivity) since they can contribute to the reduction of the model risk itself; however it would be *worthwhile to be free in setting the final maturity as well as the portion to be considered as “core” to better reflect different customers’ behaviour and volatilities*.

Were the standardized approach the only permissible representation, there would be some consequences - even in terms of ALM practices – for not being able to further use long term loans as a natural hedge of such exposures, as well as in terms of banking book economic value.

- **Demand Loans Model**

In some jurisdictions, the demand loans are considered as an alternative to short term loans, and their exposure could reach a considerable amount. This kind of instrument shares the same logic approach used for the NMDs and it can be represented with a *behavioural maturity/repricing profile*. However, the standardized Basel framework is applied only to NMDs (liabilities side) and is not extended to the asset items.

The IRRBB calculation, based on internal models (as well as the ALM practices), would diverge from the standardized calculation framework, especially in jurisdictions in which sight loans make up a significant part of the asset portfolio.

- **Expected default estimation**

Based on statistical evidence and credit models, the loans' contractual cash flows are far to be realized in full. In failing to consider the fact that some cash flows won't be realized (expected loss), the interest rate risk exposure would be likely over-hedged.

As a correction of the contractual loan cash flows, some statistical *estimations of the expected default over the time horizon of the loans* should be considered and included in the calculation.

The expected default correction - understood as the loan portion expected to default - should be estimated according to some internal models in order *to avoid over-hedging as well as inappropriately representing the risk*.

- **Prepayment**

As for industry experience, the prepayment rate should be split into two main components:

- a) A *"core" prepayment rate*, not affected by rate changes (both market and liquidity) but by other demographic factors (changes in job, divorce, etc.)
- b) A *"rate dependent" prepayment*, affected by changes in market rates as well as in liquidity spreads

The *core prepayment* is quite stable, not dependent on financial incentives and market scenarios, but reflects other demographic factors such as changes in job, moving home, divorce etc.; the *rate dependent prepayment* is, on the contrary, more volatile and scenario dependent.

Consequently, in the Basel framework, the core/demographic component which is not affected by changes in rates, should be considered separately from the rate dependent prepayment due to the fact they react differently to fluctuation in interest rates.

Furthermore, the treatment of positions with behavioral options other than NMDs (such as the ones subject to prepayment) has been limited to *fixed positions* and to *retail customers*: as for banks' experience, the core prepayment component can be observed both in fixed as well as floating positions, and both for retail as well as for non-retail customers.

In order to take all of the different features of the prepayment issue into proper consideration, institutions should be given the possibility to use their own internal models in full.

- **Mapping**

As for the standardized framework, the capital charge calculation is based on notional repricing amounts aggregated by buckets. This leads to a simplification that is not reflected in banks' common practices - especially in the most sophisticated ones - and can introduce some errors and fatal flaws in the risk calculation.

Simplifications in mapping may represent a regression for banks with an advanced risk measurement system that are able to perform a scenario-dependent, full revaluation for every single position/deal.

3. ISP agrees on a dual management and metrics

ISP agrees on the fact that higher consistency in the supervisors' approach would be desirable and be in line with the goal of achieving a level playing field within the banking sector. From a risk management perspective the measurement approach has been more focused on Economic Value of Equity, defining limits and metrics in terms of EVE Shift Sensitivity, while earnings are taken into consideration especially in order to manage its variability and to avoid the notion that a long-term perspective only could be detrimental for the short-term NII.

Consequently, ISP agrees on the importance of dual management and metrics through an Economic Value and Earning approach. As for the BCBS definition "*IRRBB refers to the current or prospective risk to the bank's capital and earnings arising from adverse movements in interest rates that affect the institution's banking book positions*". According to the above, the suggested metrics should give the right balance to the Economic Value approaches, that offer a longer-term perspective on interest rate risk, taking into account all future cash flows generated from banking book positions, as well as to the Earnings-based approaches, which are more focused on short run variability in Net Interest Income.

As for the criterion to calculate bank internal capital against IRRBB, in the gone concern scenario, ISP believes that option 4 is the best-suited among those proposed by the Committee because it allows for the inclusion of future margin levels (NIP) in the minimum capital requirements calculation in a way that it could partially offset the maximum decline in EVE (or NII if highest). For EVE, fully-hedged institutions, through a model review across banks, taking account of future margins, would need to require capital only when changes in NII will cause future earnings to fall below zero.

At the same time, ISP believes that a definition of internal capital is needed also in the going concern scenario, to measure the amount of the best quality capital that is needed to face the risk stemming from the IRRBB: losses on Earnings and Economic Value should be addressed in this business as usual scenario.

4. Disclosure requirement and Comparability

Public disclosure of banks IRRBB risk profile, measurement assumptions, qualitative and quantitative assessment of IRRBB levels and metrics is very important both for investors and depositors, as well as for the market financial stability.

However, if an appropriate level of disclosure is crucial, disclosure of the standardized calculation might be misleading. Supporting a "true" Pillar 2 approach, *ISP believes that banks' internal measurement and management should be disclosed*. The use of a common standardized framework, which may not reflect a bank's practices and customers' behaviour, giving rise to potential under or overestimation of the risk, might be detrimental.

While sharing the need for transparency and comparability, doubts arise on how to realize this significant achievement. ISP believes that the *comparability of results might not be achieved through the standardized calculation, but, on the contrary, may be guaranteed by the Regulator* itself through a model review across banks.

Disclosure of methodologies and any quantitative parameters should be the basis for the supervisory assessment, thus ensuring the aforementioned transparency and comparability in results. By insight visits and/or during the SREP process, the Supervisor should be able to evaluate the overall ALM system, procedures, processes and governance put in place, as well as internal models adopted for risk management purposes.

Simpler/smaller banks should not be prevented from using more sophisticated models and measures. However, in case internal models were not available, they should be the only ones eventually provided with a standardized framework. In such cases, *public disclosure should be based on a standardized calculation*, while the most sophisticated banks would disclose *their internal models*.