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Intesa Sanpaolo Response to the Consultation Paper on the EBA's Draft Guidelines on the treatment of structural FX under 352(2) of the CRR
(EBA/CP/2019/11)

General comments:

Intesa Sanpaolo (ISP or "the Bank") welcomes the opportunity to provide comments on the EBA's consultation paper on the treatment of structural FX under 352(2) of the CRR.

The Bank appreciates the EBA's initiative of addressing heterogeneity across the EU in the application of the Structural FX framework by providing specific Guidelines.
However, the timing of the introduction of these Guidelines raises some concerns, given the multiple and heavy impacts that they may imply for both Banks and Supervisors. We also observe how the requirements in the Guidelines sometimes seem to be an extensive and overly prescriptive interpretation of the current regulation, resulting in possible inconsistencies with the implemented framework and with the future FRTB standards, not yet in place, as well as with the different strategic business models adopted by the Banks.

In our view, the Structural Foreign Exchange (FX) Risk is not merely a banking book risk, but it can be considered a sort of strategic risk since it is mainly related to the strategic business model adopted by Banks in the different countries where they operate and underwrite macroeconomic and business risks, and not merely a market FX volatility risk.

The main principle of Structural FX Risk Management, consistent with the Bank management strategy, the Business Plan, ICAAP, ILAAP and the RAF, usually doesn't require that the related exposures are specifically hedged, based on the following considerations:

- the FX Risk stemming from investments in countries where the Group holds equity investments reflects the long-term strategic view of investing in the macroeconomic growth of these countries: any hedging would imply forgoing the additional profit resulting from the difference in interest rates compared to the Euro rate;
- for high illiquid currencies, it can be proved that over the long-term horizon, the hedging strategies tend to produce less favourable results in comparison with a non-hedging strategy;
- in general terms, over the long-term horizon, the benefits of diversifying the Group's portfolio between different currencies optimise the risk/return;
- given their nature, these net open exposures allow for the mitigation of the volatility of the capital ratios, at least to a limited extent.

Therefore, the so-called "Type - A positions" - should include both positions stemming from equity investments, measured at cost in the solo financial statement, and those whose FX risk affects the Other Comprehensive Income (OCI) Reserve as expression, on a consolidated basis, of strategic/business risk mentioned above. Those positions should be eligible for the waiver regardless of the cap, even for consolidated capital requirement purposes. Moreover, it should be even clarified that this exemption can also be applied on the FX Risk associated with Hybrid Equity Instruments issued by the Bank, considering the distinctive characteristics of this position which is held at historical cost till maturity.

The capital requirement for Structural FX Rate Risk should take into consideration the policies adopted by banks for the management of such risk, even considering the strategy encompassing the target ratios selected by each bank among all those stated in the CRR. This policy should also be approved by the Board of the bank and submitted to the Supervisor for final validation and, once validated, the related FX transactions should be exempt from Pillar 1 requirements.

As a consequence, the process for the approval of the waiver related to the Structural FX Risk should not rely on automatic calculation and formulas, but rather it should be based on a more comprehensive assessment that considers the bank's business model and the effective riskiness of

the positions held as well as the specific features of the banking group treasury operating model and the policies adopted by the bank for the management of such risk.

Concerning the eligible positions, we also observe that the Guidelines clearly state that the waiver can be granted only to banking book positions. However, this choice does not consider the possibility of adopting hedging strategies which may allow hedging FX risk also by employing trading book positions. For this reason, even the trading book position held for hedging purposes should be considered structural in nature as well (see Q9).

In addition, the EBA's Guidelines MaxOp formula is RWA driven: it implies that the optimal position is proportional to the RWAs denominated in the currency for which the waiver is requested. The consequence of this is that the larger the RWAs on a specific currency, the larger would result the waiver that can be granted by the Supervisor. This means that, given a subsidiary operating in a foreign currency, assets with lower risks would be penalised, e.g. assets to which we assign lower weights for capital charge calculation would translate in a lower denominator, thus a smaller optimal position. Moreover, at the consolidated level, the formula penalises Groups with subsidiaries holding excess capital in currencies different from the Group functional currency. To avoid this, for example, the optimal position should also factorise the contribution of the subsidiary to consolidated shareholders' equity, that in other words is even the reference for the calculation of the own fund FX valuation reserve.

We also believe that the Guidelines should address potential model divergences between legal entities for which the exemption is applied to. More specifically we deem necessary to clarify how institutions, with validated internal models at solo-level (with only some of the entities of the Group validated to internal model) should compute the net open position at consolidated basis and the own funds' requirements for market risk.

Lastly, we deem appropriate to foresee an adequate transition period (at least two years) given the multiple and heavy impacts for both banks and supervisors. In the meantime, the current applicable framework of Group's ONFEP policy and Guidelines of the Group Structural Exchange Risk should be maintained. It is worth noting that during this period the results of ICAAP and SREP assessment assures the appropriate Capital Adequacy of the bank. This transition period would also be helpful to properly calibrate the formula's parameters (see Q16).

We thank you in advance for your consideration and please do not hesitate to contact us for any further information you may have.

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Besides the above general points, we provide below our **answers to some specific EBA questions of the EBA's Consultation Paper**:

Q9. *Are there currently FX-risk positions that you kept open in the trading book for the purpose of hedging the ratio? Why did you not include such positions as part of the banking book since the main purpose of those positions is to hedge the ratio?*

When the structural FX Risk is calculated on a consolidated basis, some trading book positions, such as FX Swap included in the hedging strategy may be considered of a structural nature. The hedging strategy implies that subsidiaries may directly manage their FX exposure in a currency different than their reporting currency, through hedging operations on the market or against the parent company. Such hedging operations employ trading book instruments like FX Swap or Cross Currency Swaps (CCS), which should be considered as structural.

Q12. *Do you agree with the definition of the range in paragraph 27(d)? Do you think that 0.05 is an appropriate value?*

The formula for the sensitivity range requires the specification of a target sensitivity, defined by the bank, and employs a predetermined value (5%); we believe that such a formula is too restrictive for

two main reasons: first, it is not clear with which frequency such values need to be updated and monitored, secondly, regarding the 5% value, we believe it should be determined separately for each currency as every currency will have different levels of volatility, cost of hedging and sufficient market liquidity to execute hedges.

Q14: *Is it easy for institutions to 'transfer' the concept of a net open position in the context of the internal model? What are the methodologies that institutions may use for excluding positions for which they may receive the permission referred to in Article 352(2) from their internal models?*

The main issue resulting from excluding the eligible net open position within the internal model perimeter is procedural rather than methodological. Indeed, we see a misalignment in terms of the reference period for computing:

-   the sensitivity of the ratio to movements of FX to be hedged together with the maximum open position and;
-   the capital charge generated by the exempted structural FX-positions

In the first case, the level is set relying on the current ratio at the reporting date (stand-alone value in T). In the second case, the hedges taken to reduce the volatility for that specific ratio (assessed in T) will be required to be (potentially) capitalised at the end of the following quarter. It is worth noting, moreover, the capital charge for these positions is determined by daily PL data within the quarter.

As a result, this asymmetric mechanism might lead to:

-   a non-effective hedge (structural FX positions refer to prior capital ratio)
-   the potential exemption of a position higher than the maximum open position (over-hedges will be measured only at the following reporting date)

The above reinforces the argument that the standard methodology would be more reliable for the application of the structural FX (S-FX) provision under Article 352(2).

Q16. *Do you think that the formulas presented above provide a good estimate of the position that is offsetting the sensitivity of the ratio with respect to changes in the exchange rate? If no, why? Are there any adjustments that you would recommend? Please elaborate.*

In our opinion, a mathematical model to measure Structural FX risk would result in a too rigid framework.

Firstly, the EBA's Guidelines MaxOp formula implies that the optimal position is proportional to the RWAs denominated in the currency for which the waiver is requested. The consequence of this is that the larger the RWAs on a specific currency, the larger would be the resulting waiver that can be granted by the Supervisor. This means that, given a subsidiary operating in a foreign currency, assets with lower risks would be penalised, e.g. assets to which we assign lower weights for capital charge calculation would translate in a lower denominator, thus a smaller optimal position.

The Max Op formula is interpreted as a cap against which the net open position is compared. We believe that this leads to an asymmetry: on the one hand, the net open position includes all assets and liabilities in currency, reported as stated in art. 352 CRR; on the other hand, we consider only RWAs in currency (i.e., only assets multiplied by their weighting factors). This leads to the fact that FX positions, to be exempted, need higher RWAs to immunise the ratio. As an example, consider the case of a swap derivative: this is included in the net open position with its notional, while its contribution to RWAs in currency is reduced to its risk weight.

Secondly, we believe that for the sensitivity formula, as well as for the definition of the sensitivity range (which implies the selection of a sensitivity target for each currency) proposed by EBA's Guidelines, a grace period would be desirable so that the formulas can be subject to a monitoring process to grasp the correct calibration of such values and their volatility based on historical series.

In particular, as stated in the answer Q12, the formula for the sensitivity range requires the specification of a target sensitivity, defined by the bank, and employs a predetermined value (5%); we believe that such a formula is too restrictive for two main reasons: first, it is not clear with which frequency such values need to be updated and monitored, secondly, regarding the 5% value, we believe it should be determined separately for each currency as every currency will have different levels of volatility, cost of hedging and sufficient market liquidity to execute hedges.

Thirdly the formulas presented in the guidelines provide a quantitative definition of the capital ratio sensitivity concerning a specific FX rate. To this aim, they require some simplifying assumptions and a consistent effort to collect all data. The application mechanism of the obtained values (in particular the MaxOp, against which we compare our Net open position) seems to be excessively rigid, meaning that any change of the quantities due to FX rates fluctuations could imply a change in the optimal position of the bank.

From a mathematical point of view, many of the formulas are derived as approximations. In fact, in the equation of the optimal position, the right-hand side of the equation depends on itself from the optimal position, which makes the equation recursive. It should be clarified if the quantities on the right-hand side of the equation are to be considered as the current values.

In the specifics of the formulas, regarding the definition of Capital Ratio MaxOp, we consider the formulas as mathematically coherent only if the denominator of the following formula may be interpreted the total RWAs of the bank (balance sheet value) excluding the RWA FX for the specific currency; in other words, it can be decomposed in one part which depends on a generic FX rates and another part which does not:

$$CR_{MaxOP} = \frac{CET1}{RWA_{NoFX_{FC}}}$$