Institutional and Regulatory Strategic Advisory
Group Risk Management
Planning, Finance and Administration

UniCredit Group's reply
to the Basel Committee on Banking Supervision's Consultative Document on "Strengthening the Resilience of the Banking Sector"

1. Raising the quality, consistency and transparency of the Capital Base

1.1. General Remarks

Unicredit Group (UCG) supports the general aim of developing an internationally harmonized framework for capital requirements and considers a necessary prerequisite for any regulatory change, the enhancement of the "common level playing field" concept to avoid creating unfair competition in the market.

At the same time, however, it is of crucial importance that peculiarities of different financial systems across the world are taken into account when defining the new regulatory framework. Otherwise, despite the intention to promote a level playing field, there is a risk of discriminating against one financial system and in favor of another one.

In particular, the role played by the banking system in Europe in supporting the economic activity of the private sector[1] is much relevant when compared to US and could not be neglected while assessing regulatory changes. In fact in Euro area:

- The ratio between total bank assets and GDP is almost 4 times that of US (347% vs 92%)[2];
- Credit to non financial corporates and families amount to 120% of GDP, while in US they represent less than half that value (56%)[3];
- A higher proportion of banks' deposit is "employed" in lending to private sector: 108% vis a vis 86% in US[4];
- Non-bank credit to the private sector plays a rather modest role in respect to US: at the end of 2009 the outstanding amount of such financial instruments amounted to 2.3 trillion euros (19% of

[1] Private sector is hereby defined as "non financial corporates and families"
[2] Source: Italian Banking Association, latest available data
[3] Source: Unicredit estimate, latest available data
[4] Source: Unicredit estimate, latest available data

total credit to the private sector) as opposed to 20.2 trillion euros in the US (80% of the total credit to the private sector)[5].

The above comparison clearly states that **in Euro area the banking leverage is used principally to support the households and corporate sector and to grant lending**.

As a consequence, **more stringent requirements introduced in Euro area could reasonably have a higher negative impact on the overall supply of credit to the economy compared to the US, where there has traditionally been an easier access to capital markets by the non financial sector as well as by the banks**.

In fact, in order to maintain the same capital ratios level, banks would need to be recapitalized through common equity issuance or going on with the deleverage of their balance sheet. It would be extremely inefficient if relatively stable European banks would have to unload sound credits granted to households and non financial corporates from their balance sheets to put aside more capital to meet stricter capital and leverage requirements. Or if the higher cost to raise capital is reflected into higher spread to private sector lending**. Instead of contributing to correct for a disequilibrium, the introduction of higher and undiscriminating capital requirements in Euro area could rather deter economic recovery and growth**.

As well expressed by the European Commission[6] recently: "*If regulation is taken too far, there is a risk that this increased burden could have negative implications for the growth potential of the Euro area economy. It is important to find the appropriate balance and to ensure that , in the long run, improvements in the arrangements for financial stability translate into stronger and more sustainable economic growth*".

Another crucial theme to stress is the lack of harmonization of tax and accounting rules across jurisdictions and the related consequences arising from the introduction of the new proposed rules: the aim to homogenize the regulatory legislation, improving the quality of regulatory capital, can not disregard in fact a simultaneous harmonization of tax and accounting rules, with the risk, otherwise, to cause an undesired un-level playing field. In fact:

- accounting figures are the basis for the regulatory reporting, so no harmonized accounting figures would produce no harmonized regulatory figures, unless proper regulatory filters are set in order to sterilize the distortions;
- different tax regimes, that already impact the performance of banks as of other industries, would heavily impact also regulatory capital as a consequence of the proposed introduction of the

[5] Source: Italian Banking Association, latest available data
[6] Source: European Commission, "Quarterly Report on the Euro Area", Vol.8, N. 4

deduction of deferred tax assets. In fact where in some counties the banking system has a debt position versus the central Government, in other (as in Italy) has a credit position, that, with the new rules, has to be deducted from the capital (i.e. in the United States there are already limits to the inclusion of DTA in the regulatory capital, but the tax law also allows reimbursements of losses incurred in previous years, while in Italy tax losses can only be recovered with future profits).

In addition to assess the peculiarities of different financial systems across the world when defining the new regulatory framework, the exact timing of implementation has to be carefully considered, so that the still-tentative economic and financial recovery will not be endangered. In this respect, common grandfathering provisions should be considered, in order to allow a consistent timeframe for the implementation of regulatory rules promoted by the Basel Committee on Banking Supervision (hereby "Basel") between US and European banks.

1.2 Technical Considerations

1.2.1. Regulatory adjustments to regulatory capital

As far as regulatory adjustments to regulatory capital are concerned (minority interests, minority participation, deferred tax assets, insurance deductions, etc.), UCG believes that the approach taken by the Basel Committee is particularly severe because deductions from capital and prudential filters which are harmonised internationally, if coupled with different national legal and fiscal regimes, will further undermine the comparability in the banking sector.

We whish regulators carefully review these proposals taking into account also national perspectives and fully adjusting for any differences which could generate huge distortion on competition if applied as proposed by BCBS.

Main elements of the proposal are:

- Deduction of Minority interests: the fully deduction would create a misalignment between regulatory and accounting rules. In fact capital requirements of fully consolidated banks are considered including the minority stake (i.e. RWA are consolidated 100%). Better solution would be:
  - the deduction of excess capital of minorities, calculated on target capitalization (as defined in the ICAAP process)
  - considering RWA for equity stake excluding minorities RWA

  Furthermore we would like to underline the impact that the proposal, in his current formulation, could have on the investment in CEE countries banks, that usually take the form of majority holdings lower than 100%

UniCredit Group

- Deduction of DTA: it seems to be more correct the deduction of DTA from Tier 2 capital, instead of common equity, because of DTAs maintain their value even in going concern distressed situation as DTAs may be sold on to 3rd parties with the assets they are related.
  Furthermore, the deduction of DTA from common equity, will cause a heavy penalty for Italian banks compared to European competitors because of the peculiarities of the Italian fiscal law, leading to an unlevel playing field.
  On this regard, it would be more appropriate the adoption of a floor on which to calculate the deduction (i.e. U.S. 10% of Tier I Capital), in order to smooth the differences in fiscal regimes.

- Deduction of investments in banks, financial and insurance companies: the whole deduction from common equity seems to be excessively penalizing since increasing distortion on competitors. The aim of the deduction is to avoid the double gearing rather than cover for investment risk. In fact the risk implicit in banks, financial and insurance companies is not dissimilar to that of other investment for which any deduction is considered.
  Furthermore, if a financial institution deducts by its capital its investments in banks or other financial companies, which, on the other side, should deduct by their capital their minority interests, it would occur a case of double deduction at the banking system level.
  In addition, the deduction of the insurance shareholdings breaks the principle of equal competition within the European Community between banks and insurance companies. In fact, financial conglomerates, are subject to an additional supervision which avoid the phenomenon of double gearing and ensures a wider transparency.

- Deduction of the shortfall of the stock of provisions to expected losses: UCG agrees with the deduction, whose aim is to align from a regulatory perspective, accounting rules with effective figures of expected losses. The proposal of deducting the shortfall wholly from common equity should be considered net of taxation, in order to sterilize the delta between expected losses and provisions.

1.2.2. Tier I (Tax Deductibility)

The Basle discussion paper is questioning the tax deductibility of Tier I instruments. UCG is considering tax deductibility as one of the most important criteria to maintain instruments other than common shares in Tier I capital.

Possible impact of proposed changes: The loss of the tax deductibility feature would increase funding cost of the non-predominant element of Tier I to an extent that these instruments would no longer be sufficiently diversified from common equity. As consequence UCG would no longer issue such form of capital.

1.2.3. Criteria for inclusion in Tier I Additional Going Concern Capital

UCG proposes to limit "additional going concern capital" according to the limits provided by the CRD II. In addition, with reference to the proposed write-down mechanisms which would allocate losses to the instrument at a pre-specified trigger point, UCG believes that the write-down trigger should be objectively based on regulatory ratios and clearly communicated. In particular, the write down process should envisage the following process:

1) The write down occurs when a pre-determined total capital ratio trigger is being breached

2) Such total capital ratio shall be set at the minimum total capital ratio, which we expect to be substantially raised. We prefer the linkage of such write down trigger to total capital, in order to sufficiently differentiate it to potentially introduced contingent capital (trigger breach being linked to Core Tier I).

3) The loss absorption shall be pari-passu and pro-rata with core tier I (i.e. if the institution has 80% Core Tier I instruments and 20% non-Core tier I instruments, upon the trigger being breached, losses would be allocated 80% to Core Tier I and 20% to non-Core Tier I instruments)

4) Upon the trigger being reversed, any write-up should be allowed on a preferential basis for non-Core Tier I instruments.

The definition of a trigger breach should be assigned to the board of directors rather than left to the regulator's discretion. This is based on the following rationale: (a) the above mentioned transparency on the threshold criteria does clearly define the responsibility of the board; potential conflict of interests can not prevail (b) the definition of a trigger breach follows the approval of financial statements (c) and any trigger breach can hence be stated in a timely manner.

Possible impact of proposed changes: if the write-down mechanism was not balanced by a preferential write-up upon the trigger being reversed, Tier I instruments will effectively become pari-passu with common equity on downside risk, while being limited regarding the benefits. Such effect would no longer allow to distinguish Tier I versus common equity and hence substantially reduce the market capacity of such form of going concern capital.

In addition, UCG agree with the provisions referring to the safeguards introduced on the use of call options.

1.2.4. Tier 2 an Tier 3

Simplification is positively viewed by UCG; the elimination of Upper Tier 2 and Tier 3 instruments and the standardization of Tier 2 instruments go in the direction of harmonizing different jurisdictions and creating a common level playing field, which has always been advocated by UCG.

The regulatory concept discussed has deliberately made a distinction between going concern and gone concern capital. The clear purpose of Tier 2 capital is that of absorbing losses on a gone concern basis, thus providing additional cushion to senior creditor and depositors.

For this reason we consider it not necessary nor advisable to introduce a lock-in clause in context of Tier 2 instruments as they would only introduce a loss absorbing feature on a going concern basis to an instrument with a different purpose.

From an issuer point of view, the capital nature of instruments need to be sufficiently distinguished. This is necessary to allow stakeholders to recognize the different capital character of core capital, Tier 1 and Total Capital Ratio. Such differentiation is also essential from an investor point of view in order to attribute different pricing categories.

1.2.5. Grandfathering and transitional provisions

UCG believes that grandfathering provisions under CRD II are clear and should not be modified. As it is already envisaged, grandfathering under CRD II should be allowed until the end of 2010, whereas grandfathering under new rules proposed by Basel (hereby defined as "Basel III") should be allowed from the publication of the final proposal – presumably end of 2010 – up to and until the end of 2012, or in any case until the effective implementation of Basel III. As a consequence, the two grandfathering requirements under CRD II and Basel III will then co-exist for a certain number of years.

Possible impact of proposed changes: if, as proposed, grandfathering was granted only to instruments which have already been issued before the publication of this consultative document, i.e. 17 December 2009, this would create a dangerous conflict with the existing and legally valid CRD, and also with the proposed CRD II, which, as said, would allow for grandfathering until end of 2010.

More in particular, we believe that there is a urgent necessity to clarify this Grandfathering issue, which is effectively upholding new Tier I issuances. To one extent banks are required to hold more and better quality capital (i.e. substituting maturing Tier I, upper Tier II or Lower Tier II), to the other extent the regulatory uncertainty on grandfathering is preventing banks from such reinforcing of their regulatory capital ratios.

1.2.6 Contingent capital

We believe that contingent capital in the form recently issued would represent a useful role in the bank's capital structure. Hence we also welcome the positive recent market acceptance of contingent capital instruments (Rabobank). Benefits are represented (a) by the simplicity of the instrument in terms of creation of capital and (b) clarity of mechanism versus investor community.

The regulatory recognition of contingent capital should be either (a) its inclusion in Pillar II as to create a buffer to be used for stress tests or (b) or be included in the framework of capital buffers. Either of the two forms of recognition are a condition precedent for banks to use such instrument within the capital spectrum.

In order to make contingent capital effective for Pillar II purposes and at the same time marketable and homogeneous, the conversion trigger should be based on the Core Tier I ratio. More precisely the trigger level should be placed at the revised minimum Core Tier I ratio, which is still to be decided.

2. Enhancing Risk Coverage

2.1. Proposed additional capital charge for the Counterparty Credit Risk.

Unicredit welcomes the proposal since, at least in principle, it covers risks not fully taken into account by existing framework, it promotes a more integrated management of market and counterparty credit risk and it enhances consistency between the two frameworks

Given the above, we would like to point the issues that arise from the proposed use of the VaR of synthetic bond-equivalent:

- the measure as defined overstates capital requirements for counterparty risk since it includes not only Spread Risk but also Interest Rate Risk, that is an element of Market Risk, due to the fact that the bond notional reflects the whole exposure to adverse future

exposure variations. Modification should be done to the common VaR calculation in order to distinguish between "real" bond position and "bond-equivalent" position

- Many counterparts are not active bond issuers. Therefore a direct match to a single name CDS will fail. The firm has to use spread proxies for CVA calculation and CVA hedging. According to the BCBS proposal, such hedge will be disregarded since only hedging instruments directly referencing the Counterpart shall be recognised for the calculation of the CVA capital charge.

Our proposal is to develop a revised internal approach more sensitive to actual risk exposure that takes into account:

- Full exposure profiles instead of a constant notional of a bond-equivalent position
- Correlation between counterparty credit spreads/default probabilities and exposure sensitivities

In any case more attention should be put to avoid creating an unlevel plain field between banks which use standards methods for Counterparty Risk in respect of banks that use the internal model methods. Proposed standard methods hugely overestates capital requirements for counterparty risk.

The use of "unilateral" credit value adjustments instead of "bilateral" ones creates an overestimation of the potential risk and creates an incoherency between the regulatory measures and the measures used both for accounting (IFRS) and in pricing purposes..

2.2. Multiplier for asset value correlation for large financial institutions

Basel Committee proposed increasing the asset value correlation for large financial institutions. Applying a multiplier of 1.25 to the asset value correlation of exposures to financial firms will cause an increase of CCR capital requirement. Setting up the threshold at the level of 25 billion USD of assets will effect relations with the majority of financial institutions. Constitution the threshold at the higher level will allow to differentiate an approach to financial institutions.

UCG fully agrees that further work in calibrating the size and the assess of proposed multiplier is required.

2.3. Modified parameterisation of existing formula for CCR

Unicredit would welcome a more detailed regulation with regard to back testing of the alpha factor, leaving this framework open to national discretion would create uneven competition

The introduction of stressed effective EPE, proposed to address counter-cyclicality and reduce Wrong Way Risk, inevitably overestimates risk requirements in times of low volatility.

The increase of margin period for illiquid product, from ten to twenty days, intended to take into account more realistic market behavior in financial crisis, would unavoidably result in a totally arbitrary increase of requirements for exposures to almost all the large customers. UniCredit would welcome a recalibration approach for the margin increase that takes into account differences in the liquidity of the assets

3. Supplementing the risk-based capital requirement with a leverage ratio

3.1. Objective of a leverage ratio

The main objective of the introduction of the measure should be to prevent:

- the build-up of excessive leverage in the banking system in expansion phases of the economic cycle that can be exacerbate crisis through massive de-leverage actions
- misuse of financial innovation to circumvent regulatory capital requirements

To achieve this goal:

- the same limit should be fixed for all the banks without any distinction based on jurisdiction or business activities. This limit should be at a level able to prevent innovative financial investments' distortions without affecting traditional commercial banking activities except the prevention of overheating credit expansions
- a level-playing-field should be achieved through the implementation of regulatory adjustments to neutralize differences in regulations as well in accounting standards
- the adherence to the limit should be required at Group level only to not hinder business decisions based on optimal capital allocation and specificities of the legal and fiscal framework

3.2. Going concern capital

We are in favor of the use of Common Equity or Tier 1 as numerator of the leverage ratio since the use of total regulatory capital would reward the employment of capital instruments of lower quality.

3.3. Derivatives business and Credit derivatives

Even if we acknowledge the that from a theoretical perspective it would be better to take into account the netting mechanisms and a lower weight for off-balance sheet items, given the difficulties of the identification of proper measures and the need of define a simple and sound leverage measure, we support the implementation of the ratio in its "baseline" version, that is without netting for financial derivatives, credit derivative sold at notional value and applying 100% CCF to off-balance items since:

- would be a substantial disincentive for banks to accumulate too large derivatives books, as well as excessive positions on the short term funding markets and too large off-balance sheet commitments such as standby letters of credit, and other credit commitments

- would be easy to implement and transparent to regulators and investors

If the measure were watered down implementing netting for derivatives (credit derivatives, repos and securities financing) - to any extent - it would be run the risk that it would be not only not-effective but even counter-productive since all the burdens will weigh on commercial banks that have assets concentrated on low risk exposures, e.g. mortgaged loans to households, with impacts on availability of credit.

3.4. Ensure that it would act as an effective constraint only in benign economic conditions

UCG position is that the leverage ratio should be managed in the Pillar 2 context (and, in fact, it is already a key metric of the Risk Appetite Framework), but with a common definition across countries. More in details our position is that:

- the eventual hard limit (Pillar 1) should be set at a level achievable even under unfavorable economic condition. If the limit was binding in ordinary condition then it should be necessary to relax it during downturns, otherwise it may amplify the financial cycle
- the build-up of appropriate buffers considering adverse scenarios should be part of Capital Adequacy Process (Pillar 2). This would prevent pro-cyclical attitudes: expand assets when monetary policy is "loose" and reduce them when it's "tight"

3.5. Appropriate calibration

The majority of European banks has demonstrated the appropriateness of their leverage surviving the severity of the recent crisis. Therefore the limit set for the new measure should be achievable by the banks, with few exceptions, without radical changes in business model or dramatic changes in assets' composition.

To define the value to impose as a limit regulators should take into account:

- Profitability of the bank and of its products – if inefficient capital buffers reduce overall banks' profitability below required remuneration for capital, the institutions will be forced to swap to more riskier activities (leverage does not account for risk) to survive. As notable example, Swedish FSA noted that Big Swedish banks have about half of their portfolios in mortgages, in particular residential mortgage, versus a European norm of 20-30 percent and notwithstanding being well capitalized considering risk ratios, FSA estimates they would wind up at a ratio in the 40s while many European banks would be closer to the 20-to-30 range
- How derivatives are accounted for - As the example of Lehman Brother in the US shown, an inadequate treatment for derivatives may result in the complete failure in capturing the real leverage of an institution. The same doesn't necessary hold for traditional commercial banking activities, Basel II framework was developed leveraging on decades of experience in measuring capital requirements for these portfolios and for them risk measures can be far more effective than a leverage ratio in assessing capital adequacy

- Pro-cyclicality – to counter for the risk that an inappropriate imposition of this type may amplify the financial cycle.

4. Reducing pro-cyclicality and promoting countercyclical buffers

4.1. Cyclicality of the minimum requirement

While appreciating the effort to define proposal to limit the cyclicality of the minimum requirement, it seems too early to define, using the current information, the way to calculate countercyclical buffers. Only in the next years it will be possible to evaluate if the current situation is the negative phase of the economic cycle or, more likely, an outlier that could be used as a stress test indicator under the Pillar 2 umbrella.

It has also to be taken into consideration that the related QIS results, based on average and downturn PD, should be analysed considering the lack of PDs Basel II compliant through a complete economic cycle. Data prior the Regulator AIRB systems approval will be estimated not considering changes on both Bank/Group perimeter and currently used internal model.

Besides, the usage of the proposed downturn PDs undermine some of the more important principles defined in the Basel II Accord and carefully evaluated by the Regulators during the validation period (e.g. the development of risk sensitive parameters and their usage in the main banking processes - credit granting, risk management, capital allocation).

In the Pillar I there are already some helpful factors to mitigate the Basel II prociclicality; good examples are:

- usage of long term historical information on the calibration of risk estimates (default rates);
- usage of long term information as input factors for the risk estimates;
- usage of downturn factors in the LGD calculation;
- usage of Basel I percentage as floor for the RWA reduction.

Considering the above mentioned topics, it is deemed as more appropriate to leave the evaluation of the opportunity to held additional capital buffer versus the minimum requirement in Pillar 2.

Bank / Group ad hoc evaluation should be done in the wider dialogue with relevant Regulators and considering the already applied methodologies to deal with capital adequacy in SREP.

Moreover, the topic could be assessed not only through capital requirements but also by other techniques as stress testing.

4.2. Forward looking provisioning

Dynamic provisioning is in general a sound proposal. Without touching the risk sensitivity of Basel II an accounting buffer can be created to be used in bad times.

On accounting side there is a proposal to change IAS 39, according to which more forward looking provisions shall be created, based on an expected loss model. There are different ongoing discussions in communities how to realize this.

The crucial point for a bank is that, before a finalization of one or the other proposal, it is definitely necessary that accounting side and regulatory side harmonize their proposals:

a) Regulator problem: They propose a new kind of provisioning, that can not be applied conform to IAS.

b) Accounting problem: They propose a change in creating provisioning mostly based on Basel II values which strongly influences the Basel II capital requirements, e.g. the EL-Provisions-Comparison.

Therefore, it should be avoided the implementation of an EL-model for impairments until the interdependencies are not cleared/harmonized on a solid legal basis on both sides (regulatory and accounting).

4.3. Capital buffers

We are convinced that the current Basel II framework has many features that support system resilience and, instead of introducing new measures with limited theoretical grounds and difficult to calibrate, would be more appropriate requiring all countries to be compliant with the Basel II recommendations and in particular with the Pillar 2 requirements.

We consider retained earnings as the main source of Capital. Dividend policy and target setting have a central role in the ICAAP Process and risk appetite framework at the very heart of Basel II Pillar 2.

The current approach:

- emphasize top management responsibilities in defining risk profile reducing possible regulatory arbitrages
- enforce a counter-cyclical attitude in capital and business planning thanks to target setting through stress testing: higher buffers in expansion phases
- permits to balance, as better suits the position of the bank, idiosyncratic and systemic risk

On the contrary the introduction of targets ratios as Pillar I measures:

- would end-up simply replacing minimum requirements with an higher yardstick
- linking capital requirements to the (largely unpredictable) evolution of macro and financial variables would impair banks' ability to plan ahead for their capital needs, a key element of Pillar 2 of Basel II
- the idea of introducing mechanisms based on different macro variables for each jurisdiction would seriously impair transparency and create an uneven playing field

- new measures, to be effective, should change market (i.e. current and potential shareholders) expectations that, at present, reveal a pro-cyclical attitude: lower ratios and higher dividend in growth phases
- not to make any effort worthless the financial system stability objectives should be shared by the accounting standard setters
- the proposal to limit the excessive credit growth is too imprecise both in its content and its scope.

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