Institutional and Regulatory Strategic Advisory
Group Risk Management - Risk Integration and Capital Adequacy
Planning, Finance and Administration – Capital Management

10 September 2010

UniCredit Group's reply
to the Basel Committee on Banking Supervision's Consultative Document on "Countercyclical Buffer"

1. General Remarks

UniCredit Group (UGC) considers it very important that banks make use of upturns in the economic cycle to increase their capital buffers which can then drawn down during economic downturns. On the other hand, there is concern about introducing a fourth layer of capital, imposed on top of minimum capital requirements (Pillar 1), Pillar 2 provisions and the "capital conservation buffer". In this reply, we do not consider "forward-looking provisioning" or the capital surcharge on "systemic banking institutions" about which there is still some debate.

We understand that this instrument is, under normal circumstances, non additional capital requirements. We expect such tool to be primarily at the disposal of the authorities responsible for the systemic risk assessment (i.e. in EU European System Risk Board) benefiting from the input and deliberations of the colleges of supervisors.

Moreover we appreciate that the proposed buffer is not a constraint/limit to be complied with in the aftermath of the execution of generalised stress tests, but this points needs to be confirmed as it is not clear in the Basel text.

The main concerns are a) that the new measures may be difficult to calibrate (in part due to limited theoretical grounds), with the related risk of distortions; b) a mechanism based on different macro variables for each jurisdiction would seriously impair transparency and create an uneven playing field; c) if the competent authorities (e.g. college of supervisors) are not able to reach an agreement across various jurisdictions, the uncoordinated supervision between home and host supervisors would have undesirable and potentially damaging consequences; d) the proposal will mainly affect the economies which are still to a major part bank-financed (EU more

affected than the US); e) the euro area is not treated, as it should, as one jurisdiction for the purpose of the capital buffer.

Against this background, it is very important that regulators at least ensure the global level playing field in enforcing the full set of Basel II recommendations, and in particular the Pillar 2 requirements and features that support systemic resilience.

The recent EU-wide stress tests were aimed at verifying the appropriateness of capital levels. These exercises, which will be refined over time, constitute a good example of how target setting, that has a central role in the ICAAP process and risk appetite framework in Basel II Pillar 2, may be used to achieve the goal of a more stable and resilient financial system.

The **merits of a global enforcement of the Basel II provisions** should not be underestimated and should still be pursued:

- emphasis on top management responsibilities in defining risk profile, reducing possible regulatory arbitrages;
- enforcement of a counter-cyclical attitude in capital and business planning thanks to target setting through stress testing - higher buffers in expansion phases
- conditions to balance idiosyncratic and systemic risk

In contrast, the introduction of target ratios as Pillar I measures would end-up simply replacing minimum requirements with a higher yardstick. The following **negative consequences** also require addressing**:**

- <u>difficulty to plan capital needs:</u> 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, Basel II
- <u>unpredictable change in market behaviour:</u> in sharp contrast to the impact of the proposed buffer, nowadays investors expect banks to recapitalise during stress conditions and to reduce overcapitalisation - by means of dividends - during good market conditions. Unless regulators carefully manage market expectations, it is more likely that the market value of banks adhering to the buffer approach will be punished in every phase of the cycle.
- <u>increasing distortions due to lack of harmonised accounting frameworks</u>

- <u>unpredictable consequences on economic growth:</u> the proposal to limit excessive credit growth requires further clarification both in its content and scope.

2. Additional specific concerns:

- one of the stated purposes of this section of regulation is: "… use a buffer of capital to achieve the broader macro-prudential goal of protecting the banking sector from periods of excess aggregate credit growth …". The aim is quite wide and already addressed by other areas of regulation such as the application of a solvency ratio;
- the regulation appears to refer to the buffer related to "excessive credit growth" as an increase of the buffer related to the "credit conservation range". The interventions (conservation buffer and cyclical) should therefore be viewed in a single context. The primary concern is that each is additive in its impact, and could result in significantly higher capital requirements to cover the same risk. A deeper analysis on this topic will be possible only after the issuance of documentation on the calibration of the two buffers, the hypothesis behind the proposed range and the supporting material;
- business cycles are structural in market economies, normal swings in global economies – involving periods of above average growth and times of recession – would normally not pose a systemic threat and should be absorbed on the basis of existing ratios/rules. To identify what is a normal business cycle and an "extreme" one is subject to discretionary judgement. A wrong decision increases the risk of reducing the average growth of the economy and worse, of amplifying ups and downs.
- the causes of financial crises can be (as we have seen over the last decades) significantly different, ranging from excess in money supply to real estate bubbles and supply shocks: finding an automated (statistical) rule to identify a threshold in excessive expansion places too much confidence in economic analysis;
- the current crisis cannot be interpreted as a "normal" cyclical correction. Hence, the appropriate level of long term capital in the system should not be based only on the latest, most dramatic event. Appropriate designs of stress tests at institution level can be adopted for outliers;
- the cyclical buffer threshold is managed at country level and we can assume banks in the same country have a similar lending behaviour. The consequence is very near to fixing a second monetary target based on growth of credit masses for the private sector, with transmission mechanisms on rates and financial assets still to be analyzed. Furthermore,

with respect to the countercyclical capital buffer constituting an additional monetary policy tool, it would also reintroduce national discretion in managing money supply in the European Monetary Union, where monetary policy has been uniformly set by the ECB since 1999.

- Without a clear, defined plan of coordination among regulators, the introduction of countercyclical buffers may pose serious issues of complexity for cross border groups. First, if the imposition of a capital buffer is discretionally defined at domestic level, then political or competitive incentives may influence the regulator's decision-making process. Second, what if a host country imposes a countercyclical buffer but the home country deems the cross border bank to be sufficiently capitalized to operate in the host country? Another relevant issue of complexity for cross border groups arises with reference to the identification process of the risk "location". Suppose a loan is granted to a borrower in country X but that the borrower then uses the money to finance a project in country Y. In this case country X is where the location of the risk resides, while country Y is where credit expansion happens. In this case, for the purposes of calculating the countercyclical buffer, this credit would be "allocated" to country X even if it doesn't relate to any credit expansion in country X. Another issue arises if the countercyclical buffer is in force in the home country of a cross border bank and, as a consequence, credit is rationed in a host country where, on the other hand, credit is amply needed.
- The measures proposed would only affect banks, the treatment of other financial institution should also be solved, for instance "bubbles" created by lending from non-banks (e.g. the sub-prime mortgage bubble) will not be captured.

3. Alternative suggestion to be further investigated

- The target of the countercyclical capital buffer appears to be that of making the banking system able to sustain the credit supply in downturns, while slowing down in upward phases of the economic cycle, acting therefore as a stabilizer on capital requirement across expansion and downturn cycles. In our opinion, a simpler, more robust and more manageable criteria, in order to fulfil this **target**, could be that of **setting a minimum and maximum range for year-on-year RWA fluctuations for a given bank**. This would have made a simpler and more predictable criteria than a rule which is

triggered by a macroeconomic indicator, the predictive power of which is known to significantly vary over time and, therefore, is not always reliable.

- If this measure is implemented, a proper calibration and transition period is necessary in order to avoid undesirable consequences on the current, fragile economic recovery. In this regard, we think that the college of supervisors could be in charge of assessing, on a group consolidated basis, the implication of such a measure, in order to propose adjustment to the legislator.

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